

**Gordon Institute
of Business Science**
University of Pretoria

**Private equity growth in emerging markets: A
South African case study**

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Abstract

Private equity investment in emerging markets continues to lag that in advanced markets with many emerging countries ranking poorly as investment destinations. However, according to the Venture Capital and Private Equity Country Attractiveness Index which is sponsored by the IESE Business School Centre for International Finance (CIF), South Africa continues to be ranked as the third attractive emerging market after China and India. Further the country is the only African country to be ranked in the top 40 attractive countries for venture capital and private equity investment.

This research aims to explore the above phenomenon regarding the South African private equity industry and to understand why it is regarded as amongst the most advanced in emerging markets and ranked third after China and India, resulting in its continued growth and attraction to foreign investment capital at a higher rate than other emerging markets. The research evaluated through secondary data and exploratory semi-structured interviews, three of the factors used by the IESE Business School Center for International Finance (CIF) to measure country attractiveness for private equity and venture capital investing namely; economic activity, depth of capital markets and human and social environment.

Academic studies are characterised by macro conclusions mostly as a function of aggregation of results. This is correct in most instances and is evident in that a number of the research outcomes concur with the literature assertions as above. These are in respect of the role of economic growth, well-functioning capital market and banking systems, as well as the availability of good quality skills emanating from good training as pillars supporting the growth of South Africa's private equity industry. However, a key distinctive that the research discovered is that private equity practice is also more micro than macro, with the focus being much more on the quality of the general practitioner than his environment. It is their networks, skills, experience and ability to function as a team amongst others that attracts capital at times in markets where risk is considered high. In addition, South Africa's legal landscape in particular the Black Economic Empowerment Act which was introduced to address the imbalances of a segregated economic history, contributed a significant role in the development of the local industry in the last ten years.

Keywords

Private equity

Emerging markets

Venture capital

General practitioner

Declaration

I declare that this research project is my own work. It is submitted in partial fulfilment of the requirements for the degree of Master of Business Administration at the Gordon Institute of Business Science, University of Pretoria. It has not been submitted before for any degree or examination in any other University. I further declare that I have obtained the necessary authorisation and consent to carry out this research.

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1. Introduction to the Research Problem

1.1 Introduction

Successful entrepreneurship is always backed by sizable capital sourced from entrepreneurs own resources, borrowings from financial institutions in the form of debt, or equity investment by third parties wishing to partner with entrepreneurs (Winton & Yerramilli, 2008). However, emerging markets do not seem to be attracting similar levels of private equity capital as compared to their counterparts in advanced markets due a number of reasons (Klonowski, 2013).

This study attempts to understand why South Africa is seemingly succeeding in attracting private equity capital which appears to be eluding emerging markets. This chapter introduces the research question and the need thereof.

1.2 Research Problem

The global private equity industry is estimated at US\$ 300 billion according to the 2014 Emerging Markets Private Equity Fundraising and Investment Review (EMPEA, 2015). Despite this significant size of private equity capital, emerging markets only make about 11% of this global investment (EMPEA, 2015; Casey, 2014). Thus emerging markets are characterised by low levels foreign capital investments with particular focus on private equity capital (Groh, Liechtenstein and Lieser, 2013).

In his 2013 study, Klonowski (2013) shows that fundraising in emerging markets accounted for 15.2% of the global private equity fundraising in 2012 which is a slight increase from the 2011 figure of 14.7%. This figure did not change much in 2014 according to Emerging Markets Private Equity Association (EMPEA), which estimated emerging markets fundraising at 14% (EMPEA, 2015) of total funds raised. Reasons for this seeming deficiency in private equity investment vary from perceived high political risk, low deal flow, insufficient exit opportunities and poor regulatory environment amongst others (Klonowski, 2013; Leeds & Sunderland, 2003).

In this study, emerging markets are defined as private equity markets of all countries outside of the United States, Canada, Western Europe, Israel, Japan, Australia and New Zealand, which are collectively referred to as developed or advanced markets (EMPEA, 2014). They are divided into five main geographic regions as reflected in Table 1 below with major countries constituting them. Therefore, emerging markets

private equity funds is all private equity funds in the form of buyouts, growth capital, venture capital and mezzanine investments that principally target investments in emerging markets (EMPEA, 2014).

Table 1: Emerging Markets Geographic Regions

Market	Abbreviation	Major countries
Central and Eastern Europe (CEE), Commonwealth of Independent States (CIS)	CCRT	Russia, Poland, Turkey, Serbia, Czech Republic, Bulgaria
Continental Africa/ Sub-Saharan Africa	CA/SSA	Nigeria, Kenya, South Africa, Ethiopia, Ghana, Tanzania
Emerging Asia	EA	China, India, South Korea, Singapore, Malaysia, Indonesia
Latin America and the Caribbean	LAC	Brazil, Mexico, Chile, Colombia, Peru
Middle East and North Africa	MENA	United Arab Emirates, Morocco, Saudi Arabia, Egypt, Tunisia

Source: Klonowski (2013); EMPEA (2015)

However, in the midst of this low level of investment, the South African private equity market seems to be growing and in many respects successful (SAVCA, 2015; Klonowski, 2013). The country remains to be the Continental African region's main fundraising hub accounting for 28.2% of fundraising in 2011 of about US\$1.3 billion (Casey, 2014; Klonowski, 2013). Geographically, Continental Africa represents about two-thirds of the continent given its broad spread which covers West Africa (e.g. Nigeria, Ghana), East Africa (e.g. Kenya, Uganda, Somalia), and Southern Africa (e.g. South Africa, Zimbabwe) thus making South Africa's contribution significant in the continent (Klonowski, 2013). The Southern African Venture Capital and Private Equity Association's (SAVCA) shows that new capital raised by South African private equity firms has grown from nearly R3 billion in 1999 to approximately R27 billion in 2013 and funds under management has grown from R28 billion in 1999 to R162 billion in 2013 supporting the notion of growing industry (SAVCA, 2013).

The Africa Private Equity Confidence Survey which gives a snapshot of private equity across the continent's three largest economic regions; Southern, East and West Africa, affirms the above by pointing out that South Africa attracts more than half the continent's private equity transactional activity (McPhee & Benjamin, 2015). It accredits this dominance to a combination of factors such as market size, ease of doing business and the comparatively well-developed financial institutions and governance practices. Further, Groh (2009) indicted that South Africa had a high private equity activity level in 2007 including higher than that for advanced countries like Japan and Germany, which was also higher than that of China and India and the highest for all emerging markets. This concurs with Charvel (2012) who indicates that South Africa's private equity to

gross domestic product ratio in 2010 was the second highest in emerging markets standing at 0.37% second after India which stood at 0.61% and 0.41% for emerging Asia collectively.

This growth deserves a study to understand reasons that underscore it in the context of emerging markets which are not attracting as much private equity capital (Klonowski, 2013). The determinants of a high level activity of private equity in South Africa needs to be understood as they have a potential to benefit other emerging markets in particular the rest of the continent and local enterprises planning to invest in the continent. The study is premised on the theory that explains private equity investments mainly using advanced markets like the United States and United Kingdom where it is well established as an asset class.

1.3 Research Objectives

In the study comparing South Africa and Brazil private equity markets, Chikaonda (2012), concluded that further research should be done to generate awareness of the private equity industry in Africa. Whilst the author suggests a comparative study of African countries private equity industries including South Africa, the study did not answer the question why the South African private equity industry remains the amongst the most attractive in emerging markets and the only African country ranking in the top 50 of the Venture Capital and Private Equity Country Attractiveness Index (Groh, Liechtenstein, Lieser and Biesinger, 2015). This study therefore is an attempt to answer the latter phenomenon which remains unexplained.

Africa as an emerging market presents a number of investment opportunities which requires investment both at start-up and expansionary phases. These investments opportunities arise from the need to address infrastructure deficits as well as supply of consumer goods and services driven by growing middle class (Klonowski, 2013). McKinsey estimates that the continued growth in the emerging market middle class means that more than half of the world's population will have joined the consuming classes by 2025 (Fine, van Wamelen, Lund, Cabral, Taoufik, Dörr, Leke, Roxburgh, Schubert, & Cook, 2012).

Therefore a sound understanding of why the South African private equity market is attractive and growing is highly beneficial at industry level as the findings will add to the body of knowledge trying to understand investment and growth factors for private equity including other foreign direct investment in emerging markets.

1.4 Study Relevance

The growth of small medium enterprises (SME) is often inhibited by lack of funding be it is start-up or expansionary finance hence the role of private equity and venture capital. Venture capital as a subset of private equity (Naqi & Hettihewa, 2007; Jeng & Wells, 2000, Groh & Heinrich, 2012) played a crucial role in development and growth of entrepreneurial firms (Patricof, 1989, Charvel, 2007) in the West and Asian tigers (Naqi & Hettihewa, 2007). In a similar way, emerging markets could benefit from these investments as well. This research is an attempt to answer how emerging markets can likewise benefit for these investments as they endeavour to grow their economies.

However, of the estimated 3,000 plus private equity firms around the world, with almost 2,000 of them pursuing opportunities in emerging markets, only 16% include Africa in their portfolio (Babarinde, 2012). Additionally, of the 266 or so firms, only an estimated 13% are based in Africa, while almost 70% of them have their headquarters in Europe and North America (Babarinde, 2012; Klonowski, 2013).

It therefore becomes important to understand what lessons other emerging markets can learn from South Africa in order to be able to attract maximum private equity capital given the potential economic contribution of these investments (Charvel, 2007; Groh & Heinrich, 2012). Further, there has been little research done on understanding private equity in South Africa, a point van Niekerk & Krige (2009) acknowledge as they mention that the most comprehensive study was last done in 2006 by Missankov et al.

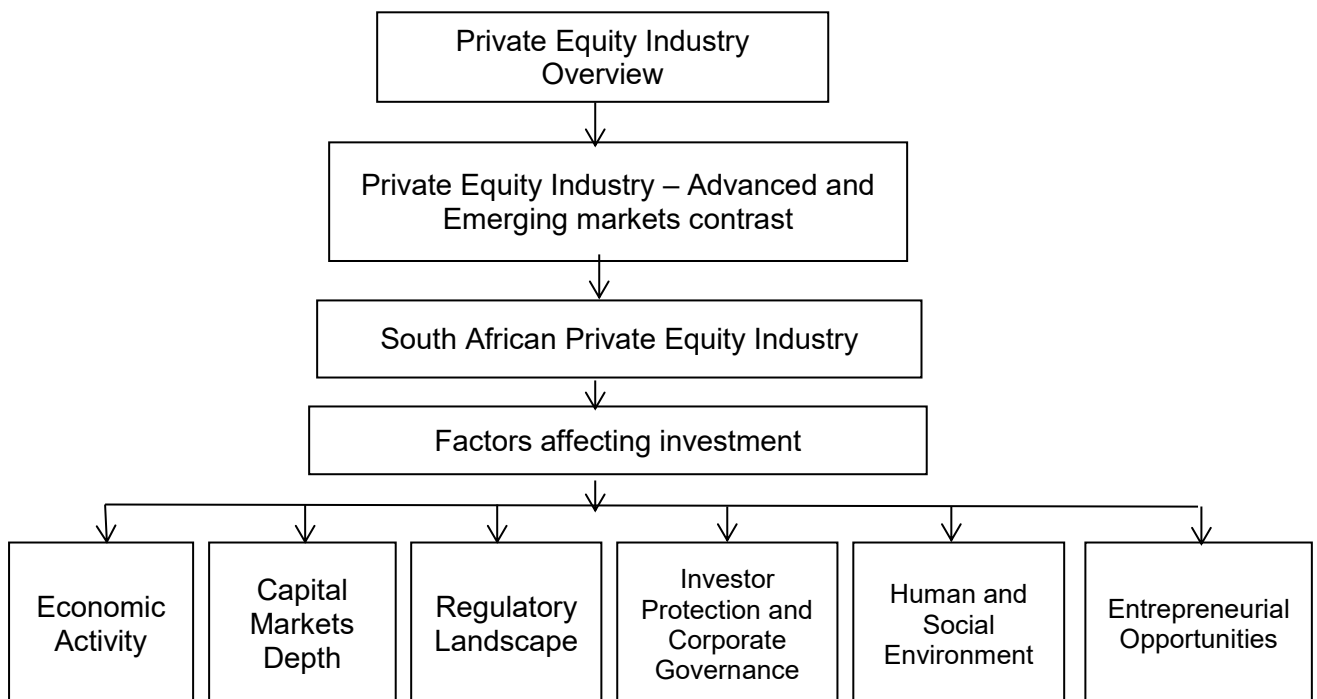
Thus this study is a contribution to the existing body of work trying to understand emerging markets as potential private equity destinations, and sources for future returns with South Africa as a case study.

2. Theory and Literature Review

2.1 Introduction

The literature and theory review depicted private equity industry as an alternative investment/ asset class starting in a global context which is primarily dominated by advanced economies. Thereafter the chapter narrowed down to private equity in emerging markets before focusing on the South African industry which was the focus of this study. In this manner, literature was used to describe private equity industry as an alternative asset class primarily focusing on key definitions, structures and factors affecting investment flow. **Figure 1** below depicts the flow of the discussion to be followed;

Figure 1: Overview of the discussion



The chapter will conclude by putting together the literature review threads presenting the importance of this study both for business and academic purposes.

2.2 Private Equity Industry

Financial systems facilitate the optimal allocation of capital to areas where it is scarce, whilst ensuring that opportunities are appropriately priced in order to yield the required returns for investors. Similarly, capital allocation directs funds amongst various assets classes like publicly listed shares, cash, bonds and what is termed alternative investments given their illiquid nature. Alternative asset class investments comprise hedge funds, private equity, venture capital, credit derivatives and real estate and the

former which normally contribute in a form of foreign direct investment (FDI) to a business environment (Makhene; 2009). As an alternative investment asset class, private equity firms' sources equity funds from private sources rather than public equity sources for purpose of investment in a company or asset (Bruton & Ahlstrom, 2003; Gregory, 2013). It is equity capital that is not quoted on a public exchange and involves investments directly into private companies or buyouts of public companies that typically result in a delisting (Bruton & Ahlstrom, 2003; Riscura, 2014; Pictet, 2014). Private equity capital is also used to fund start-ups commonly referred to as venture capital, make acquisitions or growth equity, or balance sheet strengthening (Bruton & Ahlstrom, 2003; Wood & Wright, 2009; Pictet, 2014). These applications or investment stages are reflected in detail in Table 2 below.

Table 2: Private equity investment stages

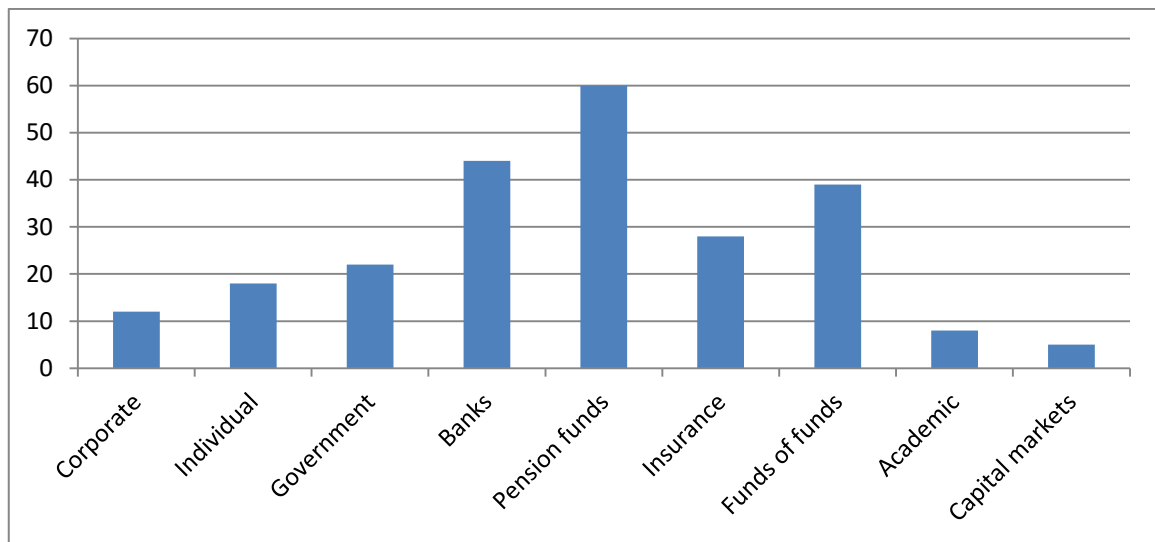
Category	Stage of business	Typical application
Venture capital	Seed capital	Funding of research, evaluation and development of a concept or business
	Start-up and early stage	Funding for new companies being setup for the development of those which have been in business for short time (1-3 years)
Development capital	Expansion and development	Funding for growth and expansion of a company which is breaking even or trading profitably
Buyout	Leveraged/ Management buyout or buy-in	Funding provided to enable management teams or other strategic partners, either existing or new, as well as their backers to acquire a business from existing owners, whether a family or cooperation or other. Proceeds from these normally go to previous owners and buyouts are often highly leveraged
	Replacement capital	Funding is provided for purchasing of existing shares from other shareholders e.g. venture capitalist, public.

Sources: KPMG (2015, p14), Gilligan & Wright (2008)

Private equity capital sources include high net worth individuals, insurance companies, pension funds, retail and institutional investors (Bruton & Ahlstrom, 2003; Pictet, 2014). Multilateral Development Finance Institutions (MDFI) also add to the list of funders for private equity funds as they encourage investment and provision of support to small and medium enterprises in developing markets (Settel, Chowdhury & Orr, 2009; Casey,

2014). Gilligan & Wright (2008) suggest that pension funds and insurance companies are significant investors in the private equity industry as they invest directly as well as through funds of funds which play an intermediary relationship with general practitioners. Figure 2 below depicts the European private equity investor spread for the period 2002 to 2006 which also shows that banks and high net worth individuals are major investors in the industry as well.

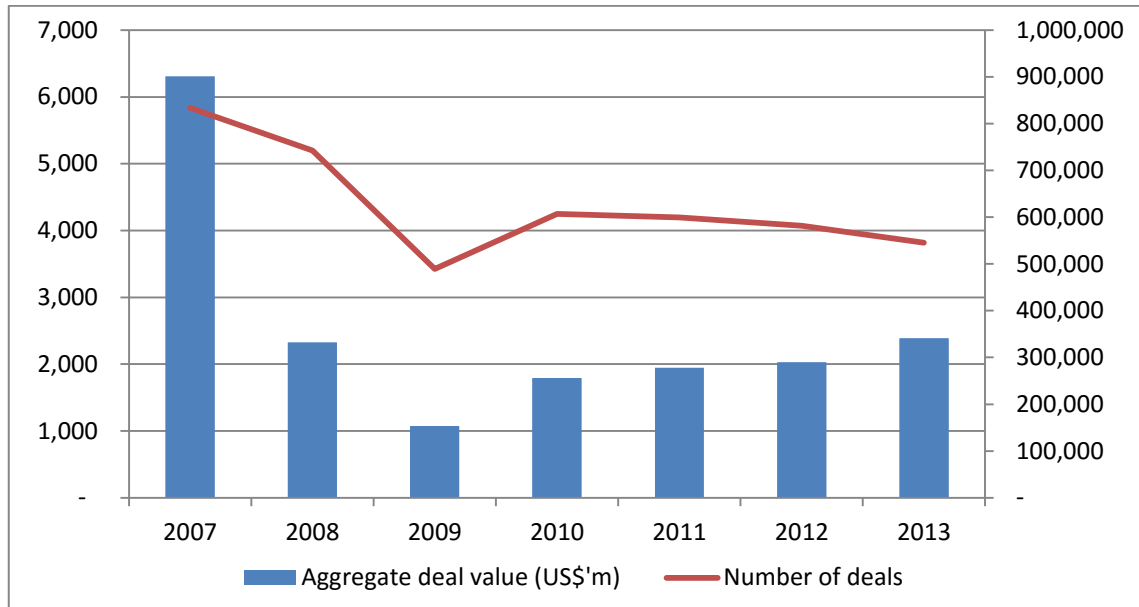
Figure 2: Europe Investors in private equity/VC funds by type for 2002-2006 (€' bn)



Source: Gilligan & Wright (2008)

According to the Bain & Company Global Private Equity Report 2015, the industry was estimated to have approximately US\$250 billion of invested funds at the end of 2014 (MacArthur, 2015) with much of this capital being in advanced markets. This is depicted in Figure 5 in the next section which contrasts advanced and emerging markets fundraising for the period 2007 until 2014. Figure 3 below depicts the global deals by volume and value between 2008 and 2013, and it indicates that most of the deals took place in advanced markets as reflected by Tables 3 and 4 which shows the top 10 countries of volume and gross transaction value as at December 2012 and 2013.

Figure 3: Deals by volume and value 2008 - 2013



Source: Zephyr Annual M&A Report Global Private Equity, 2013

Table 3: Top target countries by volume **Table 4: Top target countries by value**

Target country	Dec-12	Dec-13
US	164	119
UK	43	42
India	10	21
Spain	6	15
Italy	16	12
Netherlands	7	12
Germany	20	11
France	29	11
Canada	6	11
China	10	10

Target country	Dec-12 (\$'m)	Dec-13 (\$'m)
US	15,180	10,648
Finland	1	3,528
UK	3,529	3,000
China	246	2,052
Italy	4,411	1,709
Netherlands	1,010	1,601
Poland	0	1,100
Bermuda	0	1,000
Switzerland	469	892
Japan	1	756

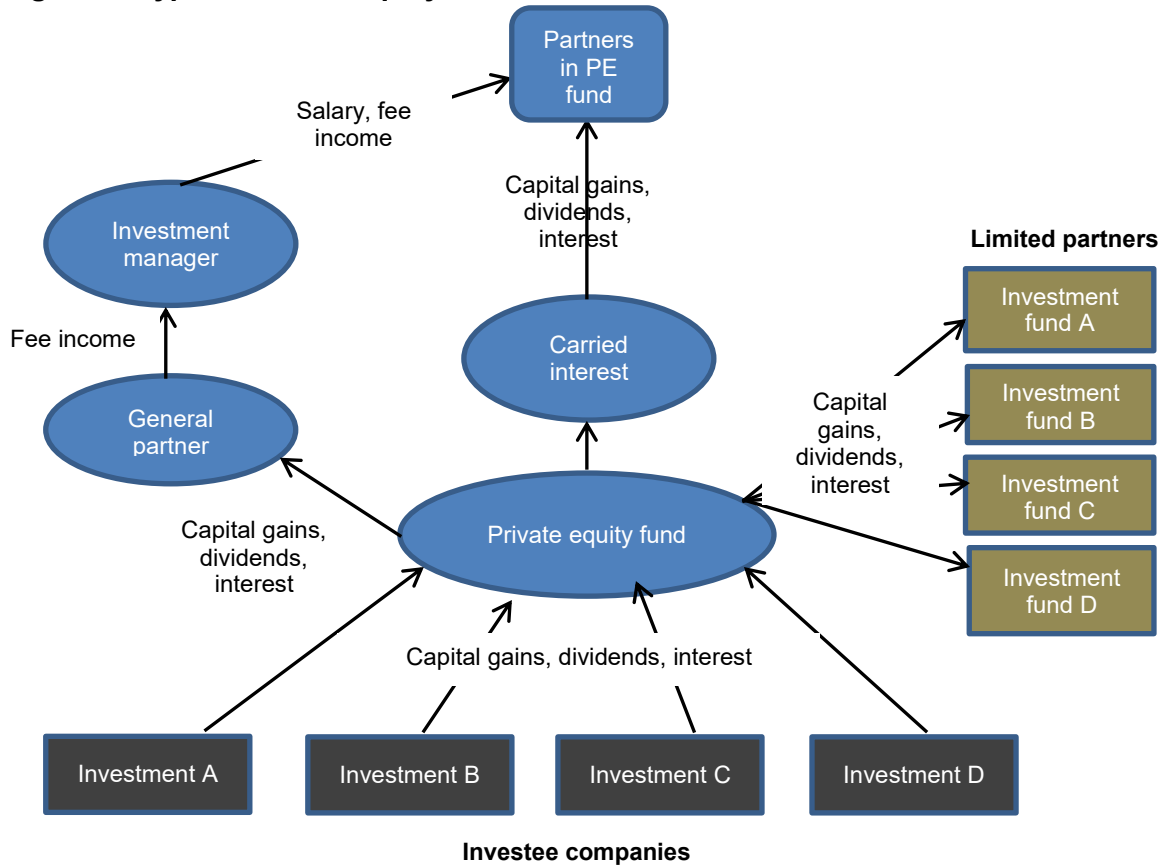
Source: Zephyr Annual M&A Report Global Private Equity (2013)

Structures

Private equity investments are generally made through a fund partnership which is a "purpose- built" general or limited partner structure (Eid, 2006; Kaplan & Stro'Mberg, 2009). The fund manager is typically a private equity professional also referred to as general partner who establishes a partnership agreement that sets forth the terms and conditions governing investment in the fund (Kaplan & Stro'Mberg, 2009; Pictet, 2014; Naidech, 2013). These normally cover the following aspects, closed-end investment structures, terms and conditions defined in a limited partnership agreement and the term of a fund which normally ranges between 10 and 12 years (Kaplan & Stro'Mberg, 2009; Pictet, 2014). In close-end structures, investors provide capital for fund

investment as well management fees for general partners. Figure 4 below depicts a classic private equity structure involving both general and limited partnerships.

Figure 4: Typical Private Equity Structure



Source: Fleisher (2008) & Gregory (2013)

In a general partnership, the partner has the legal power to act on behalf of the investment fund and is in charge of the entire investing process, including deal selection, execution, monitoring, and exiting including be liable for all debts and obligations of the partnership (Fang, Ivashina & Lerner, 2015; Heed, 2010; Naidech, 2013). This is in contrast to limited partnerships where investors play a passive role as capital providers up to their agreed commitment level for the duration of the investment period which is normally four to six years (Axelson, Stro¨mberg & Weisbach, 2009).

Private equity firms adopt different investment strategies and goals resulting in funds structured as either generalist funds, specialist funds, secondary funds or funds of funds (Heed, 2010). These funds are described in detail in Table 5 below;

Table 5: Private equity strategies

Fund type	Focus
Generalist funds	Invest in both venture capital and buy-out transactions
Specialist funds	Invest in inter alia technology, health care or telecommunications
Buy-out funds	Funds in which strategy is to acquire companies
Secondary funds	Acquire limited partnership interests in other funds
Funds of funds	Funds that invest themselves in other funds

Source: Heed (2010)

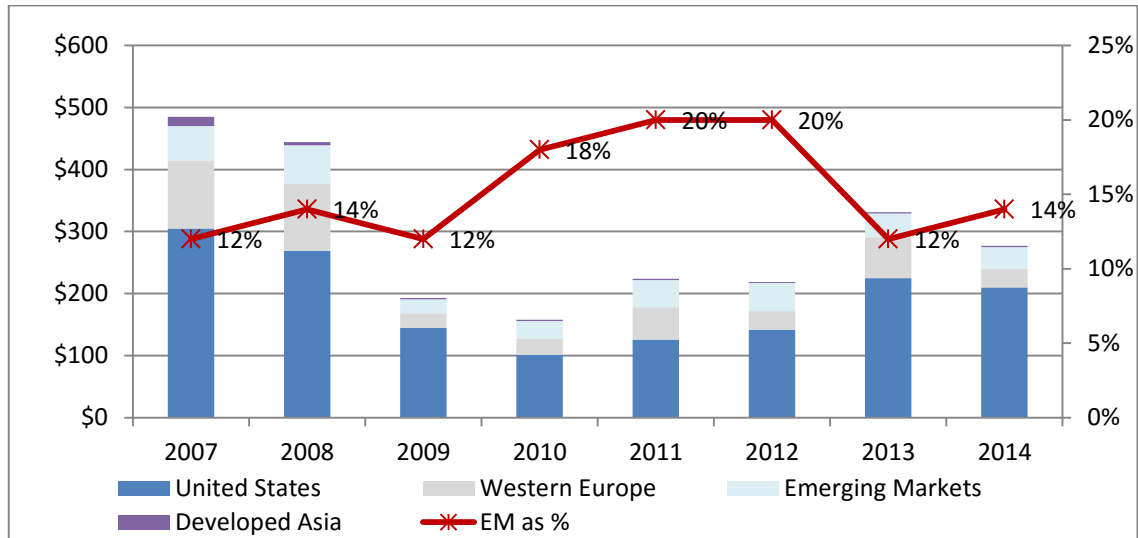
All private equity investments are driven by value maximisation of the underlying investment which is realised through exit at the end of the investment cycle (Lerner, Hardymon & Leamon, 2012; Gilligan & Wright, 2008; EVCA, nd). On exit, a portfolio investment is sold through a secondary buyout or disposal to a strategic investor or an initial public offering (IPO) and the fund distributes the proceeds back to the limited partners (Gilligan & Wright, 2008; EVCA, nd). Lerner, Hardymon & Leamon (2012) point out that successful exits with attractive returns are critical to guaranteeing the raising of additional capital for general partners. This is key because private equity investments lack liquidity during the investment period and realises this liquidity at exit (Metrick & Yasuda, 2011; Lerner, Hardymon & Leamon, 2012). The fund will then be wound up and general partners will receive payment referred to as a carried interest based on a percentage above the agreed return rate with investors (Fleischer, 2008; Lerner, Hardymon & Leamon, 2012).

In a nutshell, private equity funds differ from most funds in that they invest in illiquid, private companies and are required to return money to investors within a finite investment horizon and thus need to focus on investments with a clear path to exits upfront (Metrick & Yasuda, 2011).

2.3 Advanced and Emerging Private Equity Markets

The United States and the Western Europe led by United Kingdom represents what is normally termed as developed or advanced markets and are characterised by a high number of private equity transactions and assets under management (Casey, 2014; Klonowski, 2013). The dominance of advanced markets private equity industries is reflected in their ability to attract the lions-share of funds raised (EMPEA, 2015) as reflected in Figure 5. To place this into perspective, the global private equity fundraising in 2013 amounted to US\$333 billion with the US accounting for US\$225 billion and Western Europe US\$66 billion (EMPEA, 2015; Casey, 2014) (see Figure 5).

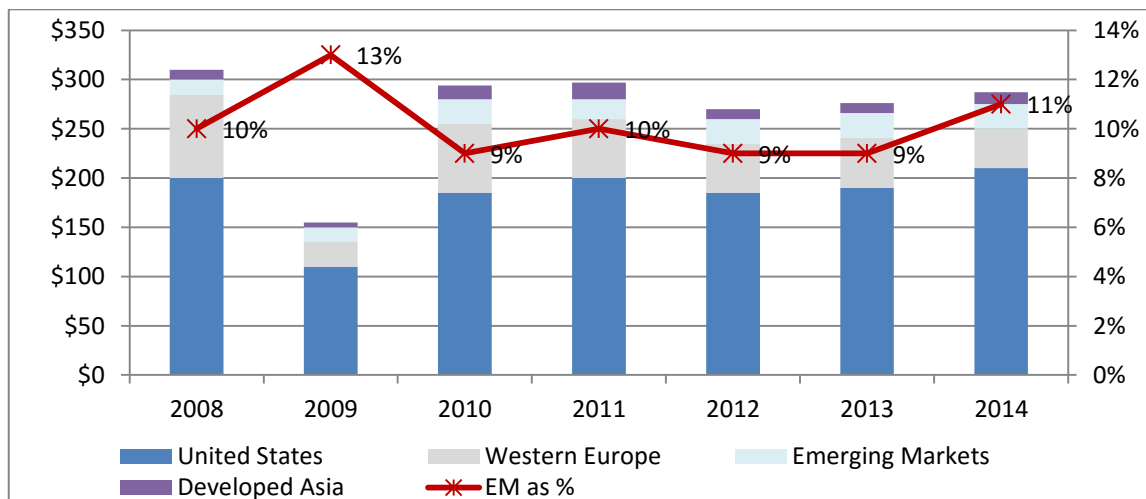
Figure 5: Private equity global fundraising



Source: EMPEA (2015), (Casey, 2014)

A similar trend transpired in 2014 as well where the US accounted for over US\$200 billion of the US\$290 billion fundraised (EMPEA, 2015). Figure 6 below further reflects the dominance of advanced markets private equity industry showing that the US and Western Europe continue to account for over 90% of global investment.

Figure 6: Global markets as % of total private equity investment



Source: EMPEA (2015)

Advanced markets are characterized by well-functioning capital markets, financial systems, adequate institutional infrastructures, stronger corporate governance and better management practices, all of which are indispensable for attracting private equity capital (Ojah, 2009; Charvel, 2012).

Emerging markets

Private equity investment in emerging markets was about 5% in 1995, and has shown a positive trend to stand at 13% in 2014 largely driven by growth in emerging markets gross domestic product (Knowledge@Wharton, 2014) supporting similar assertions as those of Figure 6 above. In contrast to advanced markets, emerging or developing markets/ economies are defined as economies with low-to-middle per capita income and cover a range of economies that are big like Brazil, India to the smallest like Rwanda (Schwab, 2014; Banerjee, 2008). As previously stated, they are private equity markets of all countries outside of the United States, Canada, Western Europe, Israel, Japan, Australia and New Zealand, which are collectively referred to as developed markets (EMPEA, 2014).

In the 2013 fundraising, emerging markets only accounted for 12% (ca. US\$38 billion) and 14% in 2014 raised despite the fact that total funds raised in 2013 had increased above 51% than the previous year. This point is depicted in Figure 6 above which shows global private equity investment from 2008 to 2014.

Emerging markets are themselves confronted by the imbalance of the capital flows. This is evident in the 2011 Asia-focused private equity fundraising in which managers planned to raise almost US\$160 billion through approximately 400 funds, whilst Africa-focused private equity firms hoped to raise only about US\$10 billion or so through 22 funds during the same period (Groh & Liechtenstein, 2011). According to Celaya, Assaad, Foran & Jurczynski (2012), Africa only attracted between 3% and 6% of total funds raised in emerging markets between 2005 and 2011, with about 73% of fund managers raising either their first (23%) or second fund (50%) in 2010.

In order to advance the development agenda, Development Finance Institutions (DFIs) like the International Finance Corporation (IFC), African Development Bank (AfDB), Dutch Development Bank (FMO), Overseas Private Investment Corporation (OPIC) have pursued investments in private equity funds focused on enhancing the development of small and medium enterprises particularly in difficult environments with weak financial markets (Settel, Chowdhury & Orr, 2009; Celaya, et al, 2012). Investments by DFI's are seen as a form of political risk mitigant thus a "seal of approval" for international investors who co-invest with the DFI as it is viewed as prestige in terms of credibility, indicates good governance and positive developmental significance (Settel, Chowdhury & Orr, 2009).

Another major benefit of DFI's investment is that it makes easier for a private equity fund with multilateral equity to increase debt financing thus serving as catalyst to mobilize even larger amounts of capital both debt and equity (Settel, Chowdhury & Orr, 2009). Therefore it is not a surprise that DFI's had invested roughly US\$7 billion in

Sub-Saharan Africa alone in 2012 which equated to between 60% and 75% of investment in private equity funds in Africa at the time (Celaya et al., 2012).

The overall poor attraction of capital by emerging markets is despite the fact that these markets are being projected with positive economic growth rates and having a sizable need for financing (Groh, 2009; Mathis, 2012). A positive development is that emerging markets are mostly characterised by a growing demographics and middle class who will come into their consuming years later on thus contributing positively to gross domestic product which in turn attracts private equity investment as it seeks higher returns (Knowledge@Wharton, 2014). Supporting this assertion; Celaya et al. (2012) states that the IFC reports that its Africa portfolio has historically outperformed its entire emerging markets portfolio posting a return of 21.7% from 42 Sub-Saharan African private equity funds between 2000 and March 2010.

The poor attraction of capital is also reflective of the weak fundamentals such as lack of preparation on the part of investee firms to receive capital, corporate governance issues, etc. that characterise emerging markets thereby making it difficult to attract capital in contrast to advanced markets (Leeds & Sunderland, 2003; Celaya et al., 2012; Klonowski, 2013). Emerging markets have poor capital and debt markets lacking sophistication and depth relative to those in advanced markets, thus making them unattractive to investors (Taiwa & Walker, 2009; Celaya et al., 2012). In addition deal sizes in emerging markets tends to be smaller and less vibrant, with longer hold times thus compounding the liquidity challenge which beset private equity investments (Prahl, Cannarsi & Zeisberger, 2011; Mathis, 2012).

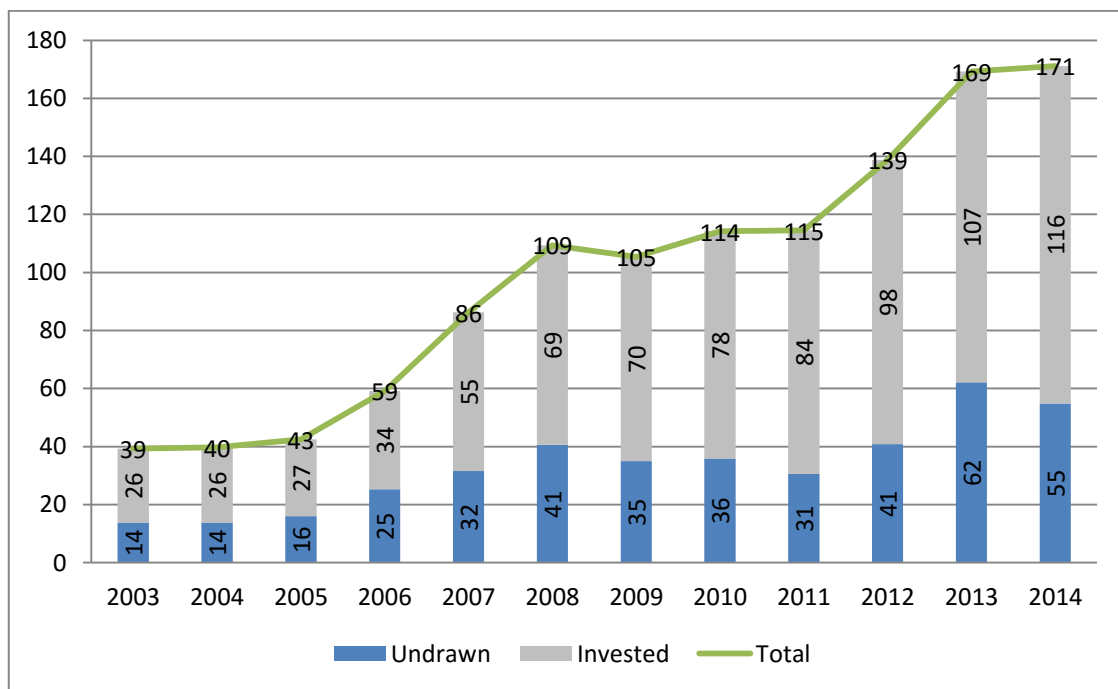
2.4 South African Private Equity Overview

The South African private equity developed on the back of the widespread multinationals disinvestment of the 1980s with transactions structured as leverage and/or management buy-outs financed by commercial and merchant banks (SAVCA, 2015). In the 1990s, most South African companies began to globalise thereby offloading their noncore local businesses in a wave of corporate restructurings making many attractive businesses available to local private equity players (SAVCA, 2015). According to the Southern African Venture Capital and Private Equity Association (SAVCA), the local industry benefited from the global trend towards recognising the asset class as an attractive investment vehicle for investors and its growing reputation as an effective means of economic development for governments and development agencies (SAVCA, 2015).

Today, the South African industry is made up of a sizeable number of independent fund

managers who manage funds on behalf of third parties and captive managers who manage on-balance sheet investments that are funded by a parent or group often from an indeterminate pool of money (Portman; 2010; SAVCA, 2015). The industry development is reflected by the growth in SAVCA full membership which has grown from 34 in 2000 to 84 in 2014, and funds under management growing from R39 billion in 2003 to R171 billion in 2014 as depicted by Figure 7 below (SAVCA, 2015). Although the local industry has grown significantly and is well developed, it remains skewed towards later-stage investment activity with little investment in the venture capital market (Portman; 2010). This skewness impacts negatively on entrepreneurship which is normally driven by venture capital, and explains why South Africa fares poorly on entrepreneurship on the country attractiveness factors as measured by Groh et al. (Jones & Mlambo, 2013).

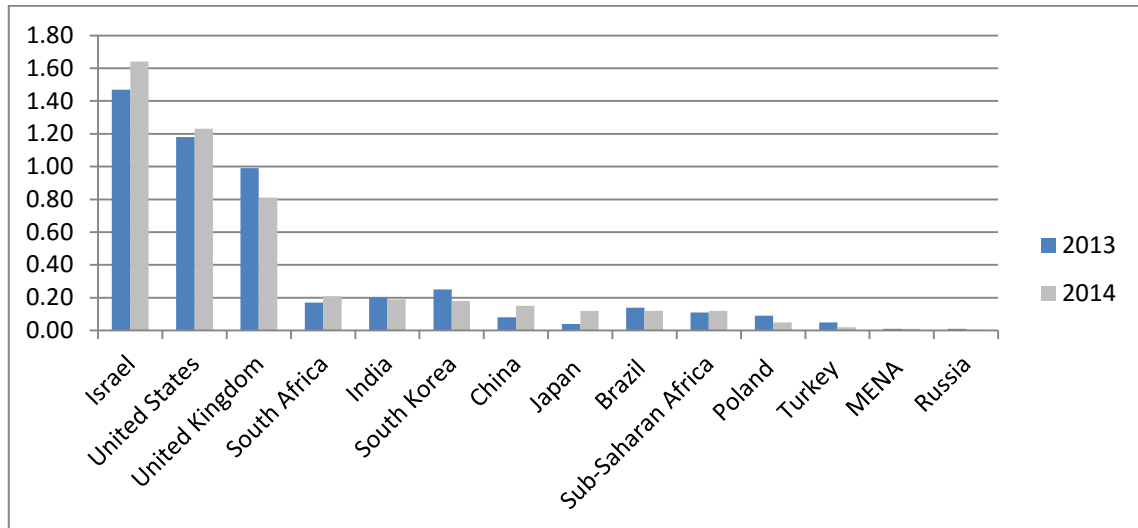
Figure 7: Total funds under management (R'bn)



Source: SAVCA (2015)

In comparison with other emerging markets, South Africa's private equity industry is described as amongst the advanced emerging markets similar to Brazil, Russia, India, China, Poland, Turkey, Mexico, Indonesia, the Philippines and Nigeria (Groh et al., 2015; Klonowski, 2013). This comparison correlates with the 2013 estimates of relative sizes of private equity in these economies which suggested that South Africa's private equity investment as a percentage of gross domestic product (GDP) equalled that of Brazil at 0.13%, in contrast to that of China at 0.07%, Russia at 0.01%, and slightly behind India at 0.2% (SAVCA, 2015; Kolver, 2014; EMPEA, 2015). Figure 8 below depicts South Africa's private equity investment as percentage of GDP against other countries.

Figure 8: Private equity annual investment as a % of GDP



Source: SAVCA, (2015); EMPEA, (2015)

South Africa attracts more than half of the continent’s private equity transactional activity according to the Deloitte 2015 Africa Private Equity Confidence Survey and continues to be the only African country to be ranked in the top 50 of the Venture Capital and Private Equity Country Attractiveness Index (McPhee and Benjamin, 2015; Groh et al., 2015).

In terms of six investment factors used for evaluating country attractiveness, South Africa compares poorly in respect of human and social environment, and economic activity when compared to Brazil, Russia, India, China, Turkey, Mexico, the Philippines, Indonesia, and Nigeria (Groh, Liechtenstein, Lieser and Biesinger, 2015).

The country’s close ties with the United Kingdom including the establishment of a similar legal and capital market-oriented culture are said to be contributing to it being an advanced emerging private equity market which compares to the likes of China, India, Turkey and Brazil (Groh et al., 2015).

In addition to the above factors; South Africa measures well on a number of factors according the World Economic Forum Global Competitiveness Index 2014-2015, all of which contribute to the growth of its private equity market against most of its peers (Schwab, 2014). These factors include the quality of its institutions which is ranked 41, intellectual property protection ranked 18, property rights at 20, and in the efficiency of the legal framework in challenging and settling disputes ranked 13 and 12 respectively (Schwab, 2014). The high accountability of South Africa’s private institutions ranked 2nd, further supports the institutional framework which is key for private equity capital and lastly, South Africa’s financial market remains impressive at 3rd place and is

amongst the most sophisticated in emerging markets (Schwab, 2014).

Another important distinctive of the South African private equity industry relates to the socio-economic measures through legislation aimed at addressing economic imbalances of the past and promoting entrepreneurial initiatives thereby increasing economic participation of historically excluded population (SAVCA, 2015). Through the Codes of Good Practice for Broad-Based Black Economic Empowerment (BBBEE), government legislated law that requires inclusion of BBBEE in major economic transactions typically at ownership level and/or management structure of the private equity managers and through the funding sources for private equity transactions which take place in the market (Missankov, van Dyk, van Biljon, Hayes and van der Veen, 2006). Thus a substantial number of transactions were driven by BBBEE activity wherein Missankov, et al. (2006) estimated that more 90% of total private equity transactions in the market and 100% of buyout transactions had an element of BEE. Van Niekerk and Krige (2009) estimated that 83% of private equity investment professionals expected their funds to have some form of BBBEE ranging from black influence to black control and that 80% of respondents felt that BBBEE will generate more opportunities for their private equity businesses. Accordingly, the industry had 267 BBBEE related investments in 2014 at a cost of R12.4 billion which was slight below that of the previous year cost of R13 billion for 236 transactions (SAVCA, 2015).

2.5 Factors Affecting Investment Flow

Private equity is classic principal-agent business practice which requires an environment of trust and clear measures for success (Groh et al., 2015). The perceived functioning of the environment influences the level of attractiveness and investment in any market resulting in high levels of capital provided (Prahl, Cannarsi & Zeisberger, 2011). Factors affecting private equity capital can be clustered into six categories namely; economic activity, depth of capital market, regulatory landscape, investor protection and corporate governance, human and social environment and entrepreneurial opportunities (Knight, 2012; Groh et al., 2015; Klonowski, 2013; Klonowski, 2011). These factors are expanded upon below highlighting how they impact on the attractiveness for private equity capital in any economy.

In a nutshell, it can be argued that the well-functioning or lack thereof of these factors determine the progression of private equity industry in a country. This research only considered comprehensively three of these elements in the South African private equity market being; economic activity, depth of capital markets and human and social environment.

2.5.1 Economic Activity

The state of a country's economy impacts its private equity market and serves as a good proxy of prosperity, assortment of corporations, and overall entrepreneurial activity (Knight, 2012; Groh et al., 2015). Diller & Kaserer (2009) suggest that the decision to enter emerging economies often hinges upon the expectations for economic growth and is more attractive if an economy is growing quickly. Markets that show high level of economic activity result in buoyancy from capital providers and leads to increased capital allocations to these markets.

The growth in the Polish private equity industry during the period 1990 to 2009 on the back of privatization transactions or spin-offs by state-owned enterprises depicts the role played by economic activity in relation to private equity (Klonowski, 2011). Klonowski (2011), further states that about 85% percent of the private equity fundraising dedicated to the CEE region was directed towards Poland during this period, and that privatisation accounted for 65% of invested capital as it became an important source of deal flow in sectors involving construction, beer, machine tools, paper, and food processing resulting in about 45 companies privatized with the help of private equity firms.

Countries that have a larger domestically based economy are more attractive than those heavily dependent on exports to fund growth, because these economies reflect an optimal combination of strong local consumerism, export orientation, private sector investment, and government investment into local infrastructure which augurs well for private equity capital (Klonowski, 2011; Fine et al., 2012). It is these opportunities that increase potential deal flows, which is the number of new deals under consideration by the private equity firm. Klonowski (2012), states that good quality deal flow often reflects the private equity firm's market reputation and its brand awareness an attribute evident in advanced markets.

2.5.2 Depth Capital Market

The success of private equity in advanced economies such as the US, Japan, Germany and UK is characterized by well-functioning capital markets and adequate institutional infrastructures, both of which are essential for an effective market for private equity industry (Ojah, 2009). Capital markets generally describe the banking system as well as financial markets which are reflected by the stock exchange. Jeng & Wells (2000) and Banerjee (2008) argue that well-developed stock exchanges are crucial for the establishment of vibrant private equity markets as they allow general partners to exit via public listings amongst others.

Floros & Sapp (2012) argues that risk capital flourishes in countries with deep and liquid stock markets because it directly reflects the returns to investors, in contrast to markets driven by banking markets which are highly conservative towards investing through debt. However, the two markets systems complement each other in facilitating capital for entrepreneurs which is key to the functioning of a successful private equity market (Winton & Yerramilli, 2008). This in turn provides secondary capital markets with mechanisms such as buyout and private transactions which are adequate to generate active and liquid secondary markets capable of sustaining private equity activities (Ojah, 2009).

The size and liquidity of a country stock market serve as a proxy for the professionalism of the financial community, thereby increasing or decreasing the country's attractiveness to private equity capital (Groh & Heinrich, 2012; Chikaonda, 2012). This may be considered as comparable to the size of the country's mergers and acquisitions market (M&A), which incentivises entrepreneurial managers and presents a preferred divestment channel for private equity, as well as deal sourcing opportunities (Groh et al., 2015). The authors conclude that the liquidities of the M&A, banking, and public capital markets provide good proxies for the private equity segment because they gauge the quality of deal-making infrastructure (Groh et al., 2015).

Since private equity takes on the entrepreneurial risk which has limited recourse in contrast to debt which takes on recourse based risk as illustrated by the various debt covenants and collateral associated with it, it requires markets that support and facilitate easy flow of funds (Winton & Yerramilli, 2008). Gilligan & Wright (2008) asserts that banks provide the 'leverage' in leverage buyouts which debt may take in many forms and can be provided by many different market participants including one or more of commercial banks, investment banks, dedicated mezzanine providers and hedge funds or similar specialist funds.

2.5.3 Regulatory Landscape

Regulation is important for the well-functioning of any industry and private equity is no exception. The objective of any fund manager is to maximise the returns to the investors, hence it is no surprise that amongst the key elements of regulation private equity has to deal with is the taxation of profits wherein the key question asked is whether profits are of income or capital nature (Fleischer, 2008; Gilligan & Wright, 2008). Profits of income nature normally attract a higher tax rate compared to those of capital nature and the cash-flow timing is also different (Fleischer, 2008; Gilligan & Wright, 2008; Groh, 2009). Chikaonda (2012) states that investors prefer markets that

allow creation of tax efficient structures as this provides relief when the company changes the way it is funded or when investors exits. In these environments managers are able to structure funds in a manner that attempt to manage the tax burden from the investee company to the ultimate fund investors in such a way as to avoid double taxation and legitimately to minimise the overall tax burden (Gilligan & Wright, 2008). A further investor consideration is how tax legislation and regulations offer opportunities for maximising returns (Watson & George, 2010; Klonowski, 2013).

There is therefore a negative correlation between a country's tax burden and the rate of return generated by investments, meaning that the more onerous the tax laws the lesser the returns for investors (Watson & George, 2010). However, Chikaonda (2012) assert that few countries have specific tax regulations on private equity investments, and that limited partnerships accrue capital gains tax on exit based on income derived from invested funds. Thus the more flexible the tax regime to minimise the effective tax rate, the more palatable it is for private equity investors.

Accordingly, if the regulatory regime of the country is problematic or unstable, private equity firms will struggle to extract value from their investee firms and will not invest in these countries.

2.5.4 Investor Protection and Corporate Governance

A country's legal system comprise the efficiency of the judicial system, the rule of law, corruption, risk of expropriation, risk of contract repudiation, and shareholder rights, all of which measure the quality of a country's legal system (Berkowitz et al., 2003; La Porta et al. 1997, 1998).

Klonowski (2011) submit that well-functioning legal infrastructure is important in creating an environment to concluding deals, executing rights, protecting the intellectual property of investee firms as well as affecting exits. Further, legal structures and the protection of property rights afforded to entrepreneurs and investors strongly influence the attractiveness of private equity markets (Groh, Liechtenstein & Lieser, 2013; Winton & Yerramilli, 2008). Winton & Yerramilli (2008), contend that the fact that law matters in aspects of finance is widely recognised because it impacts on distribution of financial outcomes such as capital structure, dividend pay-out ratios, repurchasing decisions as well as rights and protection of parties. The rate of investment and ability of a fund to properly manage deal flow including the financing of worthy entrepreneurial firms gets impacted by inefficient legal systems (Cumming, Schmidt & Walz, 2010).

The quality of a country's legal system is thus more closely related to facilitating private equity backed exits than the size of a country's stock market (Cumming, Fleming & Schwienbacher, 2006; Cumming, Schmidt & Walz, 2010). Cumming, Schmidt & Walz (2010) extend this idea and contend that cross-country differences in legality, including legal origin and accounting standards are important for private equity investors given the finite life of private equity funds. These elements are significant as they ensure that investors are protected and are able to repatriate their returns at the end of the investment cycle (Cumming, Schmidt & Walz, 2010).

Lastly, good corporate governance creates an environment and reliable outlets for resolving disputes that might arise. Remarking on the Latin American private equity industry, Charvel (2009) suggest that the poor rule of law compels investors to hold majority or controlling interest as winning strategy because it could be difficult and expensive to implement and enforce shareholders rights if holding a minority interest. This is premised on the lack of development of legal institutions in the region which explains the low level of private equity investment. Therefore, it is concluded that countries with legal systems that effectively enforce contracts have better developed financial intermediaries than countries where contract enforcement is more lax (Levine, 1999).

2.5.5 Human and Social Environment

The human and social environment looks at the ease with which suitably qualified human capital is available as well as the attitudes towards corruption. The primary function of general partnerships is provision of investment management and decisions to limited partnership (Heed, 2010). As such, limited partnerships invest based on the quality of the general partnership team expressed by experience and reputation owing to the high risk and complexity of private equity investing (Chikaonda, 2012). Most emerging markets do not have sufficiently skilled and experienced practitioners relative to advanced markets.

Another factor which is particularly important in assessing investment market attractiveness is the perceived corruption and crime levels. A society in which corruption, crime, black markets, or significant bureaucracy exist will have the highest barriers, and therefore the highest costs, to entry (Watson & George, 2010) thus deterring investment.

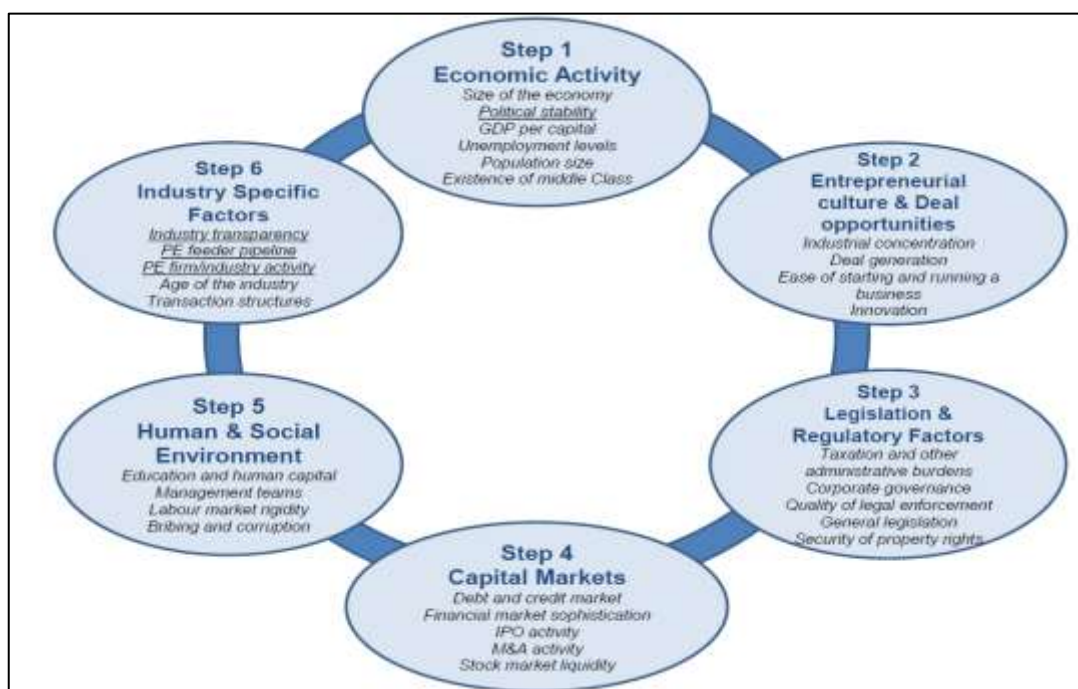
2.5.6 Entrepreneurial Opportunities

This is perhaps the most important factor in the investment decision framework as it increases the pipeline of future business to invest in. It plays a two way relationship between venture capital which invests in early stages and private equity which invest in late stages of growth and venture capital exits (Chikaonda, 2012). Entrepreneurial opportunities and activities are associated with innovations, growth expectations as well as increasing country attractiveness (Groh, Liechtenstein & Canela, 2007). In addition, the increase in entrepreneurial opportunities provides investors with balanced portfolios that achieve capital growth and income yield (Popov & Roosenboom, 2013).

2.5.7 Summary

Chikaonda (2012) suggested the model below (**Figure x**) as a tool to determine or evaluate factors that contribute to the attractiveness of private equity investment for both local and foreign investors in emerging markets. The model uses the similar elements of the country attractiveness index by Groh et al. (2015) as well factors suggested by Knight (2012) and Klonowski (2011, 2013) yet slightly differs with the order proposed by these authors. Whereas the ranking of these factors can be debated, what is important is that all these factors must be present in an economy for private equity to invest.

Figure 9: Factors contributing to the attractiveness of private equity investments for local and foreign investors in emerging markets



Source: Chikaonda (2012)

The figure states that economic activity factors should be evaluated first as they reflect the buying power of the economy in addition to the size of the economy. This is must be followed by entrepreneurship and deal opportunities to establish the diversity of companies in existence as a source of deal origination. Legislation and regulatory factors are next on the list in particular the protection of shareholder rights and enforcement of agreements including good corporate governance.

Depth of capital markets is ranks fourth on the list of factors as it creates the trading platform for investing and exiting investments. It also links to the financial systems for accessing debt and other banking products. Human and social elements are portrayed as fifth more so the importance of management teams at an investee company level which is said to be crucial in the driving of value in companies.

The last step relates to industry specific factors which are said to be the main attraction factors for private equity investment. The author argues that these factors are country specific and may not always hold in other countries and markets.

2.6 Conclusion

The literature review contextualised private equity as a global industry which follows different forms and structures to investing. The adapted country attractiveness index (Knight, 2012; Groh et al., 2015; Klonowski, 2013; Klonowski, 2011) highlights factors that drive private equity investment which Chikaonda (2012) adapts and ranks for emerging markets as per Figure 9 above.

As an enterprise, private equity is fundamentally an agent principal relationship in that limited partners provide general partners with capital for investment subject to certain macro and micro conditions being satisfactory and agreeing to predetermined fee structure and return (Klonowski, 2011; Heed, 2010; Groh et al., 2015). The partnership agreement which stipulates the return requirements, fees, investment term amongst others is the primary legal framework governing the relationship between a fund and investors (Kaplan & Stro'Mberg, 2009; Pictet, 2014).

3. Research Questions

3.1 Introduction

The aim of this study was to explore and understand the qualitative drivers of private equity industry in South Africa. The literature review introduced the subject of private equity including factors that drive investment from an academic point view. The chapter also considered the state of private equity in advanced and emerging markets in the context of literature and the impact this have on investment.

This chapter express the primary research question based on the literature review explored. The research questions were designed to gain understanding on how the functioning or lack thereof, of some of the investment factors outlined in literature contributes to the growth of the South African private equity industry.

3.2 Research Questions

Emerging markets are expected to continue along a strong economic development path and are likely to generate sound investment opportunities for global investors well into the future (Klonowski, 2013). Whilst South Africa forms part of these markets; it is described as advanced emerging market and continues to be rated amongst the top four private equity destinations in these markets (Groh et al., 2015).

The development of the primary research question was therefore based on being open-ended notwithstanding literature assertions, whilst intending to point towards a direction without being predictive of the answer (Willig, 2008).

This research was an attempt to get a deeper understanding of the investment factors the country possesses to support the growth of the local private equity industry. Thus the primary question is:

Private equity growth in emerging markets: A South African case study

The sub-questions emanating from this question are the following:

3.1.1 Research question 1

What factors led to the growth and attractiveness of the South African private equity industry as an emerging market?

This question aimed at understanding how qualitative factors in the economy, regulation, skills, financial and banking markets impacted on the South African private equity industry.

3.1.2 Research question 2

How does these factors compare with those in other markets?

The objective with this question was to get a comparative view between South Africa's industry with that of emerging and advanced markets, in particular capital providers perspective when South African practitioners consider investing outside the country.

3.1.3 Research question 3

How important is geographic location to the private equity capital providers?

The aim of this question was to understand how significant geographic location is to capital providers. The key objective was to understand if South Africa would have been able to attract similar capital flows had it been located elsewhere in emerging markets or the capital flows are influenced by other factors.

The ensuing chapter will detail the methodology used to understand the core research question as well as the supporting sub-questions.

4. Research Methodology

4.1 Introduction

The aim of this research was to get insights into why private equity capital flows into emerging economies with particular focus on South Africa which is described as an advanced emerging market. Central to this objective was to comprehend how the macro economic factors as well as micro factors at a general practitioner level contribute to South Africa's continued attractiveness to private equity capital despite the country being an emerging market. The research methodology was thus guided by the understanding that the study will be probing in nature based on discussions with general practitioners. This being a qualitative study, there was also an acknowledgement that research assumptions may be challenged by interviewees during the interview process (Willig, 2008).

4.2 Research Methodology

The aim of the study was to understand factors supporting the growth of private equity in South Africa. An inductive approach in which data was collected to get a better feel of general practitioners interactions with limited partners and developing a theory thereafter was considered the most appropriate one to use (Saunders, Lewis, & Thornhill, 2012). The theory developed was thus a substance of the data collected through interviews and the subsequent data analysis (Creswell, 2014).

In order to make the most of the inductive approach, South Africa was used as a case study in emerging markets. The case study strategy allowed for use of empirical data as well as previous research which gave extensive understanding of context to the evolution of the South African private equity industry including its current advances (Morris & Wood, 1991). All of this attempted to answer to the question 'why?' as well as the 'what?' whilst upholding agility of the process.

After establishing that an inductive approach and a case study strategy was the most appropriate; an exploratory study was determined to be fitting a method to follow to collect data as the purpose of the research was to develop an understanding of factors driving private equity investment in South Africa. Exploratory studies asked questions and clarified understanding of the answers provided so as to develop a feel of the growth of the industry in this instance (Seidman, 2012). Further, as semi-structured interviews were used to collect data, the exploratory method allowed for flexibility and adaptability to change direction when responses did not support assertions of the

literature review (Creswell, 2014; Saunders, Lewis, & Thornhill, 2012).

Interviews were considered the most effective way to gain insights into the investment rationale and geopolitical context driving growth in private equity capital flows in relation to the conclusions of published reports, theses, conference proceedings, and sector journals (Seidman, 2012). However this being exploratory, the use of semi-structured interviews allowed the researcher to cover pertinent themes to the topic from a prepared list of questions, similarly allowing for softness in the ordering of the questions and the addition or deletion of questions as needed and informed by the respondents viewpoint (Saunders & Lewis, 2012; Myers, 2013).

4.3 Population and Sampling

The South African private equity landscape is described as amongst the advanced in the emerging markets (Groh & Heinrich, 2012; Klonowski, 2013; Afanu, 2015). This is premised on measures such as the quality of institutions, intellectual property protection, property rights, efficiency of the legal framework in challenging and settling disputes, liquidity of markets and the accountability of private institutions all of which supports the institutional framework for private equity to thrive (Groh & Heinrich, 2012; Klonowski, 2013; Afanu, 2015). The country is therefore considered as Central Africa's (CA) region's main fundraising hub (Klonowski, 2013) which makes it suitable population for answering the question.

For the year ending December 2014, SAVCA which represent the industry body in South Africa had a full membership of 84 members active across private equity and venture capital (SAVCA, 2015). This represents the South African population which was used to extract the sample size taking into the description and the nature of research to be undertaken.

This being a qualitative study, there was no need to drive for numeric representation and as such a moderately small sample size sufficed (Willig, 2008; Creswell, 2014). Another factor qualitative study is not representative driven is the time consuming and labour intensive nature of data collection and analysis (Willig, 2008). The intention was to get good quality sample to assist with the understanding the local private equity market, a point Willig (2008) calls internal dynamics to the case study. Thus careful consideration had to be given who to interview and why them, how to record and transcribe the interview, what style of interviewing to use and lastly what to ask the participants (Willig, 2008).

Whereas the private equity market can be said to be homogenous, it is also heterogeneous in terms of size and investment focus as not all funds invest in similar markets with some being sector or industry specific, whereas others are non-sector specific thus generalist in nature. Funds also differ with regards to their source of funding with the two key sources being third party funds termed independents or internal funds for what is termed captive funds. The research was interested in third party funded practitioners as they interact with both local and international limited partners, thus the sample selection was stratified to include only practitioners with third party funds and exclude those with on balance sheet funding yet remaining random (Welman, Kruger & Mitchel, 2012). Random sampling allowed for any practitioner to be chosen provided they were managing third party funds (Welman, Kruger & Mitchel, 2012).

The research method adopted face to face interviews so as to allow discussion based on semi-structured questions as a first option whilst also making provision for video conferencing (Creswell, 2014). This approach had a bias towards Gauteng based practitioners although request for interviews were sought with two practitioners outside Gauteng. Thus dominance of Gauteng based practitioners was not considered a limitation as most private equity funds are concentrated in Gauteng and fit well with stratified sampling (Saunders, Lewis, & Thornhill, 2012).

The focus was private equity principals within each entity as executive heads of the funds and responsible for the approval of most of the investments (Gilligan & Wright, 2008). The principals possess considerable knowledge on factors that enabled success of historic private equity transactions as well other factors affecting emerging markets that funders normally take into account before committing to a fund.

4.4 Unit of Analysis

The unit of analysis for the study were South African general practitioners who are mainly responsible for fundraising and operating the funds.

4.5 Data Analysis

Data analysis in qualitative research requires that the researcher retreats with the data and applies analysis to finally emerge with findings in an intuitive process (Merriam, 1998). This study used a combination of comparative analysis and content analysis as the process required an iterative process of detailed examination of the contents of the

data. The interview notes and transcription were the focus was on the frequency of use of certain words and themes were used in data analysis (Merriam, 1998).

4.6 Data Collection

Data collection followed a two stage approach first using secondary data and followed by primary data through interviews.

4.6.1 Secondary Data

The starting point of data collection included literature review covering various industry related reports. The industry reports were primarily locally based from SAVCA as these are publicly available on their website in contrast to those of other associations which are subscription based like EMPEA.

4.6.2 Research Instrument

The method to gather primary data was through semi-structured interviews which allowed the researcher to elicit views and opinions from the interviewees (Creswell, 2014). Semi-structured interviews also served as memory list to ensure that the same issues are addressed in every interview and forgotten in others (Blumber, Cooper & Schindler, 2005). A further consideration was that semi-structured interviews allow data to be analysed in a variety of ways thereby making the approach compatible with a number of data analysis methods (Willig, 2008). They are also an easier way to organise compared to other forms of qualitative data collection which may be time consuming (Willig, 2008).

All interviews were done with Gauteng based funds due to cost considerations but most importantly, due to respondent's response to the request for an interview. Eight of the respondents had in-depth experience with interacting with limited partners from general partnerships perspective and the broader investment community whilst one of the responded was a local limited partner who shared that perspective. The limited partners' perspective was insightful as it gave a different perspective as will be reflected in the analysis. All interviews were done to explore the reasons supporting the functioning of the private equity industry contrasting these with the theoretical framework from secondary data.

4.7 Research Method Limitations

The following aspects are potential limitations to this study:-

- The private equity industry is a closed industry which is difficult with access particularly for interviews. Whilst sample representation was not the objective, access was not as wide as anticipated and did not include fund managers from fund of funds who play both the general and limited partner role, investment holding companies that started out as private equity firms but later changed strategy to on balance sheet funding and captive fund managers whose dynamics are slightly different but still has to deal with internal investment committees.

5. Results

5.1 Introduction

The research question is an attempt to understand reasons that underpin growth of the South African private equity industry in the context of other emerging markets. This was done qualitatively by considering three factors espoused as key for the success of private equity and venture capital by the IESB Country Attractiveness index (Groh et al., 2015). The results below are presented in a format similar to research questions in Chapter 3 with interview questions as subsets. Appendix 4 lists the codes used for the analysis of results for discussion in Chapter 6. A high level framework is given below.

5.1.1 Research question 1

Interview questions 1, 2, 5, 6, 7, 9, 10

This question aimed at understanding qualitative factors impacting on the South African private equity industry.

5.1.2 Research question 2

Interview questions 3, 8, 11

The question aimed at getting a comparative view between South Africa's industry with that of other emerging and advanced markets.

5.1.3 Research question 3

Interview questions 4, 12

The aim of the question was to understand how significant geographic location is to capital providers.

5.2 Interview sample

A total of 10 interviews were conducted with the shortest taking 21 minutes and the longest taking 60 minutes. Interviews were conducted using a semi-structured questionnaire exploring the three research questions in the South African context based on themes emanating from secondary data. The sample included private equity executives with a minimum experience of five years and mostly with a South African investment focus. Whilst experience was not a key criterion in sample selection, the idea was to target principals as they will inherently possess the minimum experience. Where a principal was not available, the researcher was assigned someone with

similar experience and knowledge based on the interview questions. Table 6 below provides an overview of the interview sample and the length of the interview.

Table 6: Interview respondents and statistics

Interview	Position	PE Experience	Gender	Length (min)
Interviewee 1	Investor relations	+ 8 years	Male	49
Interviewee 2	Associate	+ 5 years	Male	43
Interviewee 3	Principal	+ 6 years	Male	60
Interviewee 4	Partner	+ 8 years	Female	21
Interviewee 5	Associate	+ 5 years	Male	52
Interviewee 6	Partner	+ 8 years	Male	47
Interviewee 7	Regional chair	+10 years	Male	47
Interviewee 8	Principal	+ 6 years	Female	51
Interviewee 9	Investor relations	+ 10 years	Male	32
Interviewee 10	Principal	+ 8 years	Male	38

In preparing for the interviews, one of the partners who is not part of the sample, assisted with a preparatory interview which assisted in validation and clarity of the questions as well as time management. The participant also helped with access to other principals who are generally busy given their lean teams.

5.3 Research Question 1

This question reflected on qualitative factors in economic activity that investors express interest on when general practitioners look for capital. It aimed at understanding the dynamics and concerns encountered with limited partners when raising capital, implementing investing and exiting strategies in use as well as perceptions on governance, corruption etc and how these impact capital flows.

The major themes on economic activity dynamics are reflected in Table 7 below.

Table 7: Economic activity themes

Theme	No. of Respondents
GDP	9
Political stability	4
Skills availability	2
Quality of team	2
Regulation	2
Protection of minority interests	4
Development finance	3

Foreign exchange risk	2
Quality of markets	6
Market liquidity	6

5.3.1 Encountered Dynamics

There was a great level of consensus that private equity operates in a context of the country's economic growth as reflected by its gross domestic product including related factors such as skills availability, rule of law etc all of which support economic growth. Table 8 below shows the top key dynamics that feature in investor's discussion when raising capital. These were either raised in positive or negative light which is reflected below.

Table 8: Key dynamics

Theme	Positive	Negative
GDP	1	8
Political stability	4	
Skills availability		2
Quality of team	1	1
Regulation	1	1
Protection of minority interests	4	
Development finance		3
Forex risk		2
Quality of markets	6	
Market liquidity	6	

Sentiments on these dynamics are discussed below with comments from the interviewees.

Interviewee 1 expressed a view that the investment decision is not only about GDP in isolation, but other factors such as access to debt and market liquidity. The interviewee spoke well of South Africa's capital markets as a reason for the growth of the local industry in addition to the positive economic growth.

On the historic performance of the South African economy, interviewee 6 exclaimed: *"Money goes where more knows – as a bank you lend money to someone you know with history and profile"*. The interviewee further exclaimed that *"at a macro level money is going to SA where there is lots of money with proof that money came in and out therefore investors will invest because of history"*.

The same interviewee further stated that *"the turn in capital markets happens slowly – macro decisions take time to happen"* and *"money will only shift when there is a viable*

alternative market....the continent has minimal chunky investment opportunities outside government related ones". The interview further suggested that although South Africa's growth rate is not as performing as in the past, the country will still be able to attract capital because of its advanced infrastructure, relatively low political risk and availability of business to invest in.

However, whilst South Africa's macro-economic factors were cited positively for the growth of the private equity market, there were also negative aspects in relation to attracting capital currently and in the future. Some of the sentiments are highlighted below and in 5.3.2 as part of the concerns with the rest discussed under emerging themes. The following statements expressed by interviewees 1, 3 and 8 reflect the negative aspects of the South African macro-economy.

- Country (SA) is fairly developed thus it is unable to attract some capital as measured by income per capita
- Low growth rates are directing capital to West and East Africa where growth is high
- US economy is growing at higher rates which makes capital to stay (in the US) without taking political and currency risk

The above interviewees highlighted the two types of investors being those that are chasing economic growth thus higher returns and those chasing returns as well as developmental agenda hence the income per capita comparison.

A more reflective concluding remark was echoed by interviewee 9 who said; "*because growth is not the same as other emerging markets*"; South Africa historically was a good private equity capital destination, however this is changing going forward as other emerging markets are recording higher growth rates than South Africa.

5.3.2 Concerns

A number of concerns were identified in respect of South Africa's private equity industry in an emerging market context. Consistent with the results in Table 7 and 8 above, interviewees shared similar concerns as reflected below.

Interviewee 1 commented that "*a key concern is the economic growth rate and the outlook, and it is well understood that SA GDP is substantially less than other African countries (<2% vs 4-7%)*". This sentiment was shared by most of the respondents as reflected in Table 8 above. This concern is raised on the back of the continent becoming a preferred investment destination as South African growth rate lags that of

its peers. Further the country's private equity is said to have benefited significantly from developmental capital which is now redirecting focus to countries with lower income per capita than South Africa.

Interviewee 4 stated that *"lot of money is coming into the continent which needs a home or place to invest"* and that this *"increases asset prices which lowers returns"* which is a great concern for capital providers.

Interviewee 6 stated the following investor concerns;

- Political risk is of increasing concern
- Impact on ability to trade in local market (i.e. poor intra-trade)
- South Africa has massive skills shortage

Interviewee 7 expressed the following investor concerns;

- Declining growth rates, increasing corruption
- Negative perception on SA outside country
- Lack of accountability and fake qualifications

Interviewee 9 expressed the following:

- Poor growth rate, power issues, leadership, current account deficit

The interviewee further expressed that a number of South African general practitioners raises Pan African money as opposed to South African focused investment which asserts that South Africa is losing its preferred status for capital as compared to the past.

The above concerns are said to have a negative effect on the economy and South Africa as an investment destination for private equity into the future.

5.3.3 Investing and Exit Strategies

Private equity investment is dependent on availability of scalable companies, which interviewee 6 argues that they not in abundance in most emerging markets unless these companies are politically connected.

A general consensus is that investing strategies are the same with those of other emerging markets; however, some South Africa specific distinctions exist either because of the advanced economy and/or economic growth history. These are driven by networks which give access to proprietary deals, secondary buyouts, strategic sales or initial public offering on the stock exchange. Table 9 below reflects the mostly used

investment and exit strategies by South Africa's private equity industry as well as the supporting framework factors to enable the transactions.

Table 9: Exit/Investing themes

Theme	No. of respondents
Secondary buyout	7
Trade/Strategic buyer	7
Initial public offering	7
Black Economic Empowerment	2
Supporting frameworks	
Best capital markets in the world	6
Liquid financial markets	5
Good Banking system	6
Supporting regulatory and legal system	3
Entrepreneurship gaps	1

South Africa's advanced capital markets has resulted in an advanced private equity industry which made secondary buyouts where a private equity fund acquires an investment from another private equity firm a common investment strategy in South Africa, but not necessarily in other emerging markets asserted interviewee 2. Secondary buyouts is amongst the preferred methods of investing because they require minimal due diligence as private equity investments are made with a view to exit, thus preparing the company for sale according to the interviewee.

Interviewee 8 whose firm is a non-traditional private equity in that it focuses on Black Economic Empowerment (BEE) liquidity, suggested that BEE that is another distinctive investing strategy in South Africa and had contributed to the growth of alternative fund investments. The interviewee suggested that there are a number of recent private equity deals driven by BEE. This sentiment was also expressed by interviewee 3 who echoed that when a fund is deemed black, it's investment also resolves empowerment matters for the investee company because of the BEE points it accrues.

On exits, South Africa's private equity market has two additional options that do not exist in other emerging markets namely secondary buyouts and public offerings. As alluded in investing strategies above regarding secondary buyouts, these also provide a more viable exit market for South African private equity firms based on the size of the industry. According to interviewee 3, private equity exits offer potential buyers such as another private equity firms or trade buyers a good investment opportunity as they have a strong management team, strong financial position and good governance. This is premised on the notion that *"private equity managers should always think about making the business ready for sale"* the interviewee submits. This sentiment is also shared by interviewee 7 who suggested that *"private equity in emerging markets is*

preparation of governance for selling to strategic investors". The latter point was attributed as a reason for the increasing number of private equity firms in the continent as new managers buy from those who took the initial investment risk.

Interviewee 4 indicated that their first choice is trade buyers as they can extract synergies from similar businesses followed by secondary buyouts. There is a notion that trade buyers are willing to pay a premium based on the potential synergies to be extracted according to interviewees 4 and 5, a view interviewee 6 disagrees with. Rather, the interviewee argues that *"It does not matter who you sell to but it is about the right price and easiness of process"* and *"as long as you get the money you want and still look after other interests"*. In other interests the interviewee refers to employees and other stakeholders in the business that are likely to be affected by the change of ownership.

On IPO's, interviewees agreed that this is not always preferable mode of exit because of market volatility, although it is an option available to the South African industry but which other emerging markets do not have because of poor and illiquid capital markets. Exiting through an IPO requires market timing which requires listing when the cycle is high in order to realise highest exit price. Interview 3 cited a recent planned exit by one of the local firms which has been shifted out because of the market cycle being perceived to be low which will yield low exit prices.

Interviewee 4 alluded that IPO's *"requires discount and pricing is uncertain"* because it is dependent on market timing, whereas interviewee 9 states that *"listing does not fully facilitate full exits as you still need to remain invested for about 2 years to ensure continuity"*.

Similar to how BEE offers a different investing strategy, it also creates a secondary market for private equity exits in South Africa. According to interviewee 8, BEE produces an environment where it *"creates liquidity in lock-in period and a fund invest as a BEE player"*. This solves a challenge where BEE investors want money before expiry of the vesting period thus they exit fully or partially to another BEE investor at a discount.

5.3.4 Governance perceptions

Responses to the question of how investors perceived the country based on measures like Corruption Perceptions Index, World Economic Forum etc varied from concerned to being indifferent. Interviewee 9 stated that investors have never asked on this issue

as they place reliance on local institutional frameworks like Financial Intelligence Centre Act (FICA). This is also premised on the fact that the firm avoids investing in companies with ties to government contracts. Interviewee 8 also shared a similar sentiment mentioning that the one point they had to clarify with foreign investors is how BEE law works in the country as their funds are geared towards this market. Table 10 and 11 below highlights most of the themes respondents gave regarding the issue of governance perceptions and the impact of these on investment capital flows.

Table 10: Perceptions

Theme	# Respondents
Blaze (indifferent)	1
Issue not raised	5
Investors has perspective	3
Reliance on application of the law	1

Interviewee 5 stated that international perceptions are negative and that *“corruption creates un-level landscape for doing business”* which is not good for business. Interviewee 1 expressed a similar sentiment saying that *“the country has declined couple notches in recent years, but that does not mean to say investors put a line on the country”* and this is because investors make comparison with other markets for which South Africa compares well on a relative basis.

The interviewee cited that South Africa *“generally stack up well on application of the law”* and have had far less scandals compared to some of the countries. The interviewee further cited that *“investors have better perspective as they are constantly comparing us with other investment destinations”* and that *“South Africans tend to pay far more attention to the noise than people internationally do, because they have a better perspective”*.

On the point of perspective, interviewee 6 said that the *“world is a sick place and international investors have perspective in the midst of corruption”* citing how Swiss banks keep secret money from corrupt activities. The interviewee further stated, *“investors come here knowing that fault can be found with any country but it is about containing risk”* and that there are *“pockets of excellence”* in the economy.

Interviewee 7 expressed a profound response to this question saying that; *“Capital providers have more information on the country than the fund manager even though they are investing about 1% of (their) asset base”*. This shows how much energy institutional investors spend on understanding their potential markets as some of them have units focusing on studying country and political risks.

A key theme in the responses regarding poor governance perceptions was that of relative comparison with other investment destinations which gives perspective to the relative country and political risks that influence governance.

5.3.5 Impact on funds flows

Succeeding from the responses above and as reflected in Table 11 below, it is evident that the impact on the funds flows to the country is very minimal because as interviewee 2 states; *“investors put the onus on the manager to invest in correct business”* notwithstanding the broader socio-political and economic developments. Therefore the money does not necessarily follow the country or its politics and policies, but the quality and integrity of the fund managers in the country, a view also shared by interviewee 3.

Table 11: Impact on capital flows

Theme	# Respondents
None – decision is micro	8
Negative impact	1

Another reason there is minimal impact on funds is due to reliance institutional investors place on the fact that development finance institutions (DFI) turn to co-invest with them. According to interviewee 1; *“DFI’s bring confidence to investment destination in terms of rule of law compliance”* which other investors piggy-bag on.

5.4 Research Question 2

This question focussed on understanding how investors compare South Africa’s private equity capacity, skills set as well as the country as an investment destination relative to other markets. Key themes that emerged are that investing in Africa provided country diversification and is very attractive due to high growth rates being experienced, that South Africa’s good banking system provided exceptional training for private equity practitioners amongst others.

5.4.1 Investing in Africa

Investing in the rest of the continent is something capital providers welcome despite the perceptions of increased risk. Table 12 below reflects key themes that investors raise when considering investment in the rest of the continent in contrast to the country, and when discussing investment of local destined funds for co-investment in the continent.

Table 12: Investing in Africa themes

Theme	# Respondents
Attractive growth	5
Provides diversification	2
Need for local presence	5
Foreign exchange challenge	1

Investing in the rest of Africa is seen as a risk diversification strategy as interviewee 1 expressed; *“(it is) geographic diversification which helps with currency risk management”*. This sentiment is shared by interviewee 2 who said; *“they (LP) want to drive were to invest and there is increasing appetite for Africa because of high returns. The mandate is to seek returns”*.

Investment in other African countries is said to take place in USD dollars in contrast to SA where it is in rands, thus taking away the need to manage foreign exchange movements associated with investing in the rand.

Whilst investing in the continent was seen as positive, interviewee 4 expressed a growing concern of the availability of USD dollars on exit thus delaying funds repatriation process. This was sighted to be a growing trend in some of the East African countries reliant on commodities which is the source of foreign currency.

Interviewee 5 expressed the following sentiment regarding under investment in the continent; *“There is lot of interest in investing in Africa at the moment, part of it is because it is undercapitalised from an investment perspective, secondly because of sustained period of GDP growth which makes it more attractive investment destination”*. This under investment is perceived to drive investment into the rest of the continent in the near term.

Interviewee 2 expressed that most investors have strategic differentiation and look at the continent in blocks with different market dynamics. Therefore they cluster their risk profile according to the block they invest in based on the underlying country risks of each block.

However, the interest in the continent is not careless but requires local partnerships or presence in investee countries as reflected by the high number of mention by respondents in Table 12. Interviewee 9 echoed this point in these words; *“Investors do*

not want to lose money... They want to know how do you (GP) enter into other market without people on the ground". Practitioners address this concern either through investing small interest in local companies or growing a South African based company into a foreign market.

The importance of local partnerships was stressed by interviewees as this creates access to networks which are key to sourcing deals; managing them and establishing integrity of partners. This approach assists funds to address the issue of *"expertise and experience to enable execution"* of non-South Africa based investments according to interviewee 1.

Interviewee 3 stated that they are on their third fund and that it can invest up-to 20% in the continent. The 20% ceiling came as a common thread that capital providers are willing to commit to the continent for South African based funds.

A further point expressed by interviewee 9 is that; *"South African business are expanding into region (intra-regional trade) which creates opportunities for private equity funds to replicate working models into other regions"*. In the interviewees' mind, South African practitioners are able to establish local presence in other countries using models used in locally.

Whilst investing in Africa is growing and attractive, interviewee 5 expressed concern of the *"lack of uniformity of legal framework across countries"* which creates a challenge.

5.4.2 Market participants

On the size of market participants, interviewees all agreed that the South African industry still has room for new participants as reflected by Table 13 below. Interviewee 1 asserted that after the change of Regulation 28 of the Pensions Fund Act increasing the upper limit for investment in alternative assets from 5% to 10%, *"virtually none of them are at the 10% limit"* and that private equity is *"competing for 10% of the 75% of pension fund assets under management"*. The 75% is after deducting the 25% allowed for offshore investing by pension funds.

Table 13: Industry participants themes

Theme	# Respondents
There is still room	7
Intermediation	1
Skills	1
Transformation	2

Interviewee 4 stated that *“compared to India and China there is still has long way to go”* and that *“currently all deals are proprietary i.e. one on one, whereas in developed markets these are done through a banker who auctions for best price”*. Therefore in the interviewees view, only when the local market is intermediated through auctions will it reach a saturation point.

Interviewee 9 suggests that South Africa’s *“penetration is low at about 1% of GDP compared to about 5% in UK/US”*. However the interviewee pointed out that new entrants has a challenge in raising money due to lack of track records.

Interviewee 6 argued that the lack of skilled and experienced professionals limits the number of fund managers. In support of his view, the interviewee stated that *“PIC is allocating R50 billion for private equity but this will be difficult to place”* due to the lack of skills.

Interviewee 2 who is a local limited partner lamented the fact they are forced to choose from the same pool of managers given the small pool of fund managers in the country. He argued that there is more scope for black managers in line with the country’s transformation agenda a sentiment also shared by interviewee 8.

5.4.3 Skills set adequacy

South Africa with an advanced private equity market compares with the best in respect of skills adequacy and training. This is because of the industry having *“being around for some time with a lot of people working in it”* according to interviewee 1. This experience was acknowledged by seven of the respondents as reflected in Table 14 below. Another theme raised related to industry transformation which 3 interviewees alluded to. This theme is discussed in detail under emerging themes in section 5.6 below.

Table 14: Skills adequacy themes

Theme	# Respondents
Quality experience	7
Financially based skills	4
Transformation	3

In agreeing with the sentiment of skills abundance, interviewee 7 stated that the industry has an *“oversupply of potential entrants allowing managers to pick the best”* thereby leaving a sizeable pool given that most managers have a low headcount base.

Interviewee 5 stated that South Africa's practitioners are *"highly skilled and amongst the best in the world, consistently reaching top performance"*, however the interviewee indicated that capacity is *"small relative to more mature markets"* but *"might see growth because of liberalisation and institutional investors wanting to invest in PE funds"*.

One of the contributing factors to the exceptional skills sets was linked to training which has its roots in financial skills as noted by four respondents. In South Africa, most practitioners are chartered accountants (CA) who according to interviewee 3 *"have well rounded experience on governance, valuations, coming from investment banks"* a view shared by three other respondents. The interviewee also mentioned that *"feeder sectors such as corporate finance houses, MBA...assists non-CA's with MBA with good analyst training programmes"*.

Whilst the general views were that of sufficient skills capacity and good training, interviewee 6 held differing views suggesting the industry is *"under resourced for the opportunities"* and that there is limited experience in the local market. In the interviewees view, a person *"needs at least 10 years' experience to be a good PE practitioner"* and *"should have concluded 27 deals to be properly experienced"*. However this comment was made in the context of the sluggish transformation in the industry, for which the lament was that few blacks take up senior positions in the industry which in turn contribute to this weak experience.

5.5 Research Question 3

The last question aimed at establishing if location had any influence for capital providers, and whether they place any premium on the location where the practitioners experience was obtained. Interviewees shared a similar sentiment that location is not a major factor; instead the practitioner's track record in the particular market was most important supported by the rule of law and other macro factors.

5.5.1 Geographic location

Interviewees largely agreed that location does not give South Africa an advantage to attracting private equity capital, rather its developed capital markets, rule of law and quality of practitioners do. Interviewee 1 suggested that there are investors who still see the country as entry point into the continent.

A key issue to the success of any private equity industry is the state of capital markets which are needed to enable access to liquidity, debt and good governance according to

interviewee 1. Therefore location played a very minimal role towards the development of the local industry according to the interviewee.

Interviewee 10 stated that the investment decision has more to do with the general practitioner rather than the location; stating that: *“it is about relationships, who you know and knowing what to avoid, possessing market intelligence which gives access to proprietary deals”* which is important for capital providers. Thus the theme of local presence was highlighted as influential in deciding on capital allocations for investors.

5.5.2 Training

On the issue of international versus local experience, interviewees were in agreement that the source of training and experience does not influence how capital providers perceive capability. Instead capital providers place more reliance on the quality of the team and experience in the local networks as these are more important to executing private equity transactions.

Interviewee 4 underlined this point by saying; *“funders want feet on the ground as this gives access to proprietary deal flow and fraud and bribery”* and that *“you can always bring international experience/skills when needed”*. In the interviewees mind private equity is about understanding local culture and networks and not so much the transactional issues.

Interviewee 9 said what is important is about how the team worked together, a point echoed by interviewee 8 who stated that *“it is about track record and how the team works together and governance”*. This point was echoed by interviewee 3 who ascribed success of their firm to the low turnover and that the team has been together for more than eight years thus singing from the same hymn song. Investors want to see this common understanding in the team.

Interviewee 7 emphasised the point of *“local people for local markets”* because of *“networks and understanding cultures”*. The interviewee pointed out that *“private equity is about understanding local culture and networks because of the marriage tenure”*. In his view, given the long-term nature of private equity investment, this is similar to a marriage hence the need to understand local market dynamics likely to be encountered and how to respond to them.

Interviewee 1 stated private equity is about *“home markets where expertise was developed and demonstrated track record that they generate returns”* which is

important to investors. This point reiterates the fact that private equity is micro and not macro as asserted by literature.

5.6 Emergent factors

The semi-structured questions were exploring themes emanating from literature review as investment attractiveness factors. Given their semi-structured natures interviews allowed for new factors to emerge based on responses. In responding to the South African context, three factors emerged as important for understanding growth of the local private equity industry. Table 15 below reflects these new factors and the number of respondents for each factor.

Table 15: Emergent themes

Theme	# Respondents
Racial Transformation	4
Gender parity	1
Importance of local presence	3

5.6.1 Transformation

Industry transformation is said to have contributed to a number of black fund managers who in most instances were first time funds. This point was made clear by interviewee 10 who is a local capital provider who stated that *“we do not back up first-time managers except for BEE”*. BEE was said to have driven the recent mergers and acquisition activity according to interviewee 6 as companies wanted to comply with legislation.

The need for transformation was lamented by interviewee 2 who said *“South Africa’s private equity industry is still racially based with less people of colour”*. This view was also shared by interviewee 8 who argued that black fund managers are not asking for relaxation of performance and quality standards, but wants similar standards as those for non-black fund managers to apply.

5.6.2 Gender parity

The question of gender parity is in many respects a world phenomenon. Thus it is not surprise that out of the total of 10 interviewees, only 2 were females, one white and another black. Interviewee 8 lamented that *“there is bias towards white male CA”* and also mentioned how difficult it was for her to enter into the industry despite having the skills and possessing an MBA.

5.6.3 Local experience/presence

A key factor that emerged in all interviews is that private equity practice is micro instead of macro with the focus being on the fund manager. Fund managers are measured on their track record which reflects the quality of the team, but more than anything else, their knowledge and experience of the local environment they operate in.

This point was emphasised by interviewee 2 who said “*GP’s need to be closer to the investment*”. As previously noted in 5.5.2 above, interviewee 4 said “*funders want feet on the ground as this gives access to proprietary deal flow and identify fraud and bribery*” and “*you can always bring international experience/skills when needed*”. A similar sentiment was expressed by interviewee 7 who said “*local people for local markets*” because of “*networks and understanding cultures*”.

The conclusion is that the general practitioners experiences and knowledge of the local market is important for the success of private equity which is primarily soft skills as opposed to hard and technical skills.

5.7 Conclusion

The interview results have painted a slightly differing picture to literature by pointing to the micro nature of private equity. A key factor in the success of private equity is the quality of the team, its knowledge of the local market and track record in that market followed by its skill set. Whereas macro factors are important and form the basis of academic literature and the broader supporting environment, interviewees’ responses allude to the fact that as an industry, private equity is more micro and about relationships in the market of operation. Networks giving access to proprietary information is important for investors.

The next chapter will discuss the above results in detail in full contrast to literature with the aim to make meaningful contribution of new knowledge and insight into the subject of private equity investment in emerging markets.

6. Discussion of Results

6.1 Introduction

The interview results in Chapter 5 assists in understanding and providing insights behind South Africa's private equity industry growth. This chapter will analyse these results in light of the academic literature introduced in Chapters 1, 2 and 3. The study used indicators from the Venture Capital and Private Equity Country Attractiveness Index (Groh et al., 2015) and Klonowski (2013) as a base for interviews as well as answer the primary research question. The discussion below will follow a similar approach using research questions as headings and indicators as subheadings. These indicators namely economic activity, depth of capital markets and human and social environment are embedded in each of these questions and the discussion of results will follow this approach.

6.2 Research Question 1

This question explored the qualitative factors that investors express interest in when general practitioners seek capital. It aimed at understanding the dynamics and concerns encountered with limited partners on implementation of investing and exiting strategies in use, perceptions on governance and how these impact capital flows.

6.2.1 Economic Activity

In the literature review, Diller & Kaserer (2009) suggested that investment in emerging markets is mostly based on expectations for economic growth. This view, which is also shared by Knight (2012) and Groh, Liechtenstein and Lieser (2013), asserts that macro-economic factors impact a country's private equity investment and is amongst the key dynamics investors raise with general partners.

The majority (9) of interviewee's concurred with these sentiments citing that South Africa's historic growth rates made investment in the industry very attractive as it provided great returns, and that it continues to do so although to a far lesser extent as countries in the continent are exhibiting higher growth rates than South Africa. The latter point is intensely reflected by the concerns limited partners express regarding the state and outlook of South Africa's economic performance and other related aspects such as political, social, leadership etc.

In addition to the above, three interviewees introduced the element of developmental capital also termed impact investing which strives to stimulate growth in economies

they provide capital to and have less entrepreneurial activity. Thus emerging markets with lower per capita income relative to South Africa are becoming preferred investment destinations for these capital providers reducing the pool of funds available towards the South African private equity industry. These views concurs with sentiments expressed by Settel, Chowdhury & Orr (2009) and Celaya, et al. (2012) on the role of DFI's in enhancing the development of enterprises in weak financial markets which South Africa was historically. They also affirm the statement that DFI's are used a "seal of approval" in developing markets thus giving institutional investors comfort to invest as argued by Settel, Chowdhury & Orr (2009).

The state of the economy thus plays both a positive and a negative role in the development of private equity industry, and South Africa has historically benefited from developmental funding as major funders of private equity. The developed economy is now starting to work against the country as it is no longer perceived as developing based on the high income per capita relative to other emerging markets.

6.2.2 Depth of Capital Markets

Interview questions 5, 6 and 7 were focused on understanding capital markets qualitative factors. In chapter 2, Jeng and Wells (2000) and Banerjee (2008) argued that well-developed stock exchanges are crucial for the establishment of vibrant private equity markets as they allow general partners to exit via public listings amongst others. The same view is shared by Groh, Liechtenstein and Lieser (2013) and Groh et al. (2015) who argue that liquidity of capital markets serve as a proxy for private equity as they gauge the quality of deal-making.

A total of six interviewees agreed with the literatures sentiment in that South Africa's capital and financial markets played a key role in the development of private equity industry in the country. This is because South Africa's capital markets ranks amongst the best in world thus making them a major attraction relative to other emerging markets. Whilst IPO's are not always the preferred method of exit as suggested by interviewees 4 and 9, South Africa's stock market remains the most liquid amongst emerging markets which is pivotal for private equity growth.

Groh & Heinrich (2012) and Chikaonda (2012) argued that the liquidity of the capital market reflects the professionalism of the financial community, a point supported by Floros & Sapp (2012) when talking about the relationship between capital and banking markets the latter which provides debt funding in contrast to equity funding. The importance of this relationship was expressed by interviewee 3 who expressed a

sentiment that because banking system is well developed and understand funding models, they readily provide a term-sheet when needed by enterprises. This may be either for working capital, growth capital or acquisitions. This supports assertions by Gilligan & Wright (2008) that banks provide the 'leverage' in leverage buyouts which debt may take in many forms and can be provided by many different market participants including. It also supports Ojah's (2009) view that debt funding support active and liquid secondary markets for enterprises buyout and private transactions which are important to sustaining private equity activities

Interview responses highlighted two distinctively South African factors not covered by literature mainly BEE and first time funds which are linked to BEE. BEE investment steered a number of deals in the country over the past few years as noted by interviewee 8, as well by interviewee 10 who mentioned that they do not fund first time funds unless they are black.

These views concur with Van Niekerk and Krige (2009) and Missankov, et al. (2006) assertions on the role of BEE in the development of private equity in South Africa. Van Niekerk and Krige (2009) estimated that 83% of private equity investment professionals expected their funds to have some form of BBEE, whereas Missankov, et al. (2006) estimated that more 90% of total private equity transactions had a BEE element.

The depth of South Africa's capital markets supported by its banking markets backs literature's assertions on the support this provides for effective investing and exit for private equity industry. The liquidity of the stock exchange enables exiting through IPO's although they are not always the preferred method of exit due to market volatility. This is further supported by the country distinctive factors of BEE investments and funding for first time fund managers.

6.2.3 Human and Social Environment

Interview questions 9 and 10 considered the governance perceptions and skills factors emanating from discussions with investors. Watson & George (2010) argued that corruption, crime, black markets and the likes deter investment as they increase the cost of investing.

Whereas the view of literature is reasonable, interviewees painted a different picture sighting that investors have a broader perspective on the country relative to other investment destinations. As result, five interviewees mentioned that capital providers have not raised the question of fraud and corruption in their discussions. Interviewee 1 expressed the fact based on relative perspective, South Africa stacked up positively

because of the rule of law despite performing poorly on corruption index and the likes.

It was interviewee 7 who articulated well-articulated fact on how investors develop perspective by saying that; “Capital providers have more information on the country than the fund manager even though they are investing about 1% of (their) asset base”. Thus the point that private equity is micro instead of being macro is further supported by this approach of relative comparison.

Therefore based on this comparative approach, eight interview respondents mentioned that there is no impact on the capital flows. Interviewees further highlighted the reliance institutional investors place on DFI’s governance rules as co-investors, which fund managers have to abide by.

Literature assertions are therefore not fully supported by data which paints a different picture about investors approach to investing. They don’t just paint everything with the same brush but weigh each destination on its own merits.

6.3 Research Question 2

This question aimed at considering investors comparison of South Africa’s private equity capacity, skills set as well as the country as an investment destination relative to other markets.

6.3.1 Economic Activity

Interview question 3 focussed on understanding investor sentiments on investing part of the South African raised funds in the continent. As noted above in 6.2.1, investors are driven by expectations of economic growth as suggested by Diller & Kaserer (2009), as well as assortment of corporations and overall entrepreneurial activity as argued by Knight (2012) and Groh, Liechtenstein and Lieser (2013).

The same is true according to five interviewees who indicated that the expectation for growth in the continent has caught the attention of their capital providers. Capital providers are open to part of South African funds being invested in the rest of the continent given the growth expectations. Amongst all interviewees, there was mention that investors are willing that upto 20% of the South African fund be invested in the continent subject to clear risk mitigation strategies.

The primary risk mitigation takes place through local partnerships or presence as

expressed by five interviewees. Interviewee 9 expressed investors' concern on this point in these words; *"Investors do not want to lose money... They want to know how do you (GP) enter into other market without people on the ground"*. Thus for investing in the continent South African funds take a minority interest approach if they invest directly in a country alternatively they invest in South African business with potential to have African footprint.

On the entrepreneurial activity and availability of scale enterprises, interviewee 7 lamented the fact that these do not abound in the continent unless politically connected. However, the interviewee concurs with literature on this being a key factor in driving private equity investments in a country including South Africa. The interviewee argued that the reason private equity capital still flow to the country is because of the abundance of medium sized enterprises with potential to scale-up.

The last theme interviewees raised is that investing in the continent provides risk diversification, and is a natural hedge against currency risk as investment takes place in US dollars which is also the currency of returns to investors in contrast to South Africa where investment is made in rands but returns are measured in dollars.

6.3.2 Depth of Capital Markets

Interview question 8 explored this point by trying to understand relative capacity of the South African market to that of advanced markets and the size of the local economy. Groh, Liechtenstein and Lieser (2013), Groh & Heinrich (2012) and Chikaonda (2012) argue that the size and liquidity of a capital market reflects professionalism of the financial community, as well as the size of M&A and quality of deal-making infrastructure. This indirectly reflects on the question of the country's capacity to execute on available opportunities.

The majority of interviewees, seven in total, agreed that for the size of the local economy, South Africa still has room for additional capacity in the form of new fund managers. This view is premised on the fact that the current 10% allocation towards alternative assets by pension funds of which private equity forms is virtually untapped as expressed by interviewee 1. Another factor is that the industry primarily transacts on proprietary deals without the need for intermediaries as is the case in advanced markets as mentioned by interviewee 4.

South Africa is said to have a practitioner penetration level of about 1% of GDP in contrast to about 5% in the UK/US which further echoes the fact that there is room to increase the local capacity for private equity in the country.

6.3.3 Human and Social Environment

The last comparative point relates to the human environment in terms of the adequacy of local skills in contrast to advanced markets as captured by interview question 11. Heed (2010) argued that the general partnerships primary function is to provide investment management and decisions to capital investors. Chikaonda (2012) suggested that investor's decision is based on the quality of the team as expressed by experience and reputation owing to the high risk and complexity of private equity investing.

South Africa's private equity grew on the back of the banking system in particular its merchant and investment banking. It has already been noted in 6.2.2 that South Africa's banking system is amongst the best in the world, which implies that the quality of skills will compare with that of advanced markets. This is a sentiment acknowledged by seven of the interviewees thereby concurring with literature on the need for good experience. Commenting on this experience, interviewee 5 cited that South Africa's practitioners are *"highly skilled and amongst the best in the world, consistently reaching top performance"*.

The financial training foundation which dominates the industry is credited with *"well rounded experience on governance, valuations"* as was mentioned by interviewee 3 and concurred by other three other interviewees. Additionally, the local industry was said to have good feeder sectors in corporate finance and analyst training programmes which contribute to the quality of good skills and experience.

The general sentiment thus supports literature on the need for good skills and training despite the fact that one interviewee lamented lack of experience in the local market. This comment was mentioned in the context of transformation which is one of the emergent themes under skills and is discussed later.

6.4 Research Question 3

The last research question was aimed at establishing the importance of location for capital providers, both as an investment destination as well as a source for training and experience. This question was not linked with any specific literature but attempted to under if there is a correlation between the investment factors and location.

6.4.1 Economic Activity

Interview question 4 aimed at establishing if South Africa's location had any influence on the industry performance or whether this was a function of other externalities. In research question 1 and 2, the significance of the macro economy as reflected in GDP as well as the quality of investment teams were established as important for private equity industry. This view is shared by interviewees who alluded to the fact that the quality of teams and practitioners, functioning of capital markets and the rule of law are key underpinnings of South Africa's private equity industry.

Therefore the South African industry would have still accomplished similar results even if it was located elsewhere.

Well-functioning capital markets enable liquidity which creates investing and exiting platforms for the industry as well access to debt as supported by the banking system. The last point related to the quality of the team in the context of understanding local trading environment and culture. Teams build their track-records in a context, therefore good quality teams build strong networks that help navigate their environment to discover new opportunities, avoid scrupulous partners and finally make good returns.

6.4.2 Human and Social Environment

Similar with the economic activity above, the question intended to establish if investors place any premium on training obtained in advanced markets relative to local one. Since South Africa's training platforms compares with those in advanced economies, interviewees expressed that training in advanced markets does not attract any special attention from capital providers. Instead it factored down to the practitioners understanding of local environment including networks which are key to deal sourcing and exiting. Interviewee 1 argued that it is about markets where expertise was developed and track record demonstrated which is key for investors. Interviewee 4 argued that international skills can always be brought in when required as there are mostly transactional in nature and not private equity which is relational in nature.

The conclusions of research question 3 point to the fact that private equity is more about micro factors and not so much macro as suggested by literature.

6.5 Emergent factors

Literature typically has limitations as it is based on generally used norms, definitions and factors as it enables uniformity of analysis. In a similar manner there were factors that emerged from the interviews which are significant for understanding the development of South Africa's private equity industry.

6.5.1 Transformation

South Africa has a history of a racially divided economy which impacted on access to opportunities for blacks and other non-white races. Although the country did turnaround the political and legal environment that perpetuated discrimination thereby creating uneven platforms, transformation of operational issues like the economy still lags. It is in this context that BEE plays a transformational role in deracialising the industry with support offered to first time black fund managers amongst others as well investment opportunities for black owned funds or funds whose major beneficiaries are black. Thus BEE has played a significant role in the development of private equity in the country noted by interviewee 2 and 8 as well interviewee 6 who articulated that a number of M&A in the recent past have been driven by BEE.

6.5.2 Gender parity

The subject of gender parity is somewhat a world phenomenon as most executives worldwide are male and thus not unique to South Africa. It is therefore not surprising that of the ten interviewees only two were females and one of them being black. As an emergent factor, the interviewee lamented the need for the industry to transform from being male dominated to acknowledging that females are equally capable of being good practitioners as well.

6.5.3 Local experience/presence

Local presence as a qualitative factor sums the major part of the research in that it points to the micro nature of the industry as opposed to the macro. Investors invest in practitioners, who are present in locations they invest in, possess networks that give them access to proprietary deal flow and understand the local market dynamics and culture amongst others. It is the quality of the practitioner's track record in those markets that determine whether a practitioner is excellent or not and by inference the industry's development, performance and attractiveness. Interviewee 4 expressed this view in the words "*funders want feet on the ground as this gives access to proprietary deal flow and identify fraud and bribery*". Interviewees were agreement that where

required, international transacting experience can always be brought in when required to support the underlying private equity industry.

6.6 Conclusion

The research questions were aimed at exploring why private equity is growing in South Africa relative to other emerging markets. Whereas literature highlights a number of factors as important to the development of private equity country attractiveness as suggested by (Knight, 2012; Groh et al, 2015; Groh, Liechtenstein and Lieser, 2013; Klonowski, 2013), these take a macro outlook which makes for easy comparison. It therefore makes sense that literature indicators will rank economic activity as number one, followed by depth of capital markets, legal and regulatory landscape, investment protection and corporate governance, human and social environment and entrepreneurial opportunities. The study only looked at three of these indicators namely economic activity, depth of capital markets and the human and social environment in the South African context to understand the extent they contributed or not to the growth of the local industry.

There has been convergence on the role of most of the qualitative factors as reviewed in literature in Chapter 2 and data collected thereby supporting the assertions of literature. At the same-time, a major thread that emerged from data analysis is that private equity is micro rather than macro in its functioning with lot depending on the practitioner's team, experience, track record and networks amongst others. This changes the model suggested by Chikaonda (2102) as per Figure 9 in 2.5.7 from starting with economic activity to starting with the quality of the team as reflected in Figure 10 below.

Figure 10: Key factors to private equity growth



This model stresses the importance of the micro aspect of private equity functioning in an economy. Whereas dependent on the macro factors, it is largely about how the practitioner operates guided by knowledge of the local environment and quality of skills set. The South African private equity industry has displayed this interdependency in that its world class banking system produced exceptional investment skills supported by a growing economy and well-functioning capital markets, hence its growth relative to other emerging markets in the past. In addition the country legal system which ensured

protection of rights amongst others created an enabling and supporting environment for foreign capital to invest.

In conclusion, the study affirms Klonowski's (2013) assertion regarding private equity in emerging markets that "the true race among global private equity players is to establish their local footprint, develop effective local contacts, nurture local relationships (whether political or business), improve a strong and proprietary deal flow, and develop a local talent base". These are the true success factors for any private equity industry notwithstanding the role of the macro economy and other macro factors. The South African industry is excelling in all these aspects supported by the broader macro environment.

7. Conclusion

7.1 Introduction

The research has shown that private equity functions much more at a micro level than at a macro level thereby challenging the macro nature of academic literature. Academic studies are generally at macro level based on the relative ease of results aggregation which this study is not immune to. Notwithstanding these differences, the study has validated the overall literature conclusions when taking a historical view of the South African private equity industry.

7.2 Principal findings

When considering the elements that make a country attractive for private equity investment, the sophistication of South Africa's financial markets has augured well for the growth of the local industry and making the country attractive to capital providers thus supporting assertions by Gilligan & Wright (2008) and Groh et al. (2015) on the role of capital markets.

The well-functioning and international acclaim of the country's financial markets supports Jeng and Wells (2000), Banerjee (2008) and Floros & Sapp (2012) assertions that these markets are crucial for the establishment of vibrant private equity market and that risk capital flourishes in such markets because of their liquidity.

The historic growth of the country's economy has also played a pivotal role in the development of the local industry thereby concurring with (Knight, 2012; Groh et al., 2015) assertions that economic activity is crucial for the growth of private equity industry and making the country attractive for investment. Further, the suggestion that the decision to enter emerging economies often hinges upon the expectations for economic growth as espoused by Diller & Kaserer (2009) has been confirmed by the research. This is particularly true when considering the current trends in the flow of capital towards other emerging markets and investing in Africa as reflected by Research Question 2.

Although capital follows economic growth as it offers high returns, it was noted that the quality of the general practitioner as reflected by knowledge of local market, skills and experience is also a very important factor in capital allocation.

The country's well-functioning financial and banking systems are good breeding ground to gain experience for private equity practitioners thereby providing the necessary investment management experience to navigate the highly risky and complex nature of private equity investing as alluded by Heed (2010) and (Chikaonda, 2012). This experience compares with those of advanced markets and continues to make the country attractive.

The research outcomes has pointed that investors are continuously evaluating countries as potential investment destinations and this shapes their perspective on matters of fraud and corruption at country level. As such they develop a highly comparative viewpoint and analysis of country risks notwithstanding measures like the corruption index which Watson & George (2010) cite as deterring to investment.

In South Africa's case, the country's upholding of the rule of law and efficiency of the judicial system has played a crucial role for the growth of the industry thereby concurring with Berkowitz et al. (2003) and La Porta et al. (1997, 1998) assertions that these reduces the risk of contract repudiation and protects shareholder rights. The country's legal system ensures protection of property rights is afforded to entrepreneurs and investors strongly influence the attractiveness of private equity markets as argued by Klonowski (2011), Groh, Liechtenstein & Lieser (2013) and Winton & Yerramilli (2008).

7.3 Implications for management

The research has indicated the need for more detailed research to understand investor's sentiments in the allocation of capital. The inclusive view that considers only macro elements has the potential to limit management and entrepreneurs like general practitioners in taking the necessary entrepreneurial risk necessary.

7.4 Limitations of the research

Any research has inherent limitations primarily driven by time and cost constraints which are basic elements required for determining and achieving both the scope and depth of study. In this case, the following aspects are considered potential limitations to this study:-

- a) The study did not attain the desired sample representation it preferred with particular focus on investment holding companies that started out with a private equity funding model but later changed strategy to being on balance sheet funding. Inclusion of these companies would have shed more light into the dynamics raised by investors when raising capital. Another exclusion to the

sample was the local fund of fund managers who would have given a perspective on why some limited partners prefer to outsource that role to an intermediary as well as understand their considerations.

- b) There is minimal literature on private equity in emerging markets which limits the depth of literature review. This is particularly true for South Africa where the last comprehensive study was done in 2006 according to van Niekerk & Krige (2009).

7.5 Suggestions for future research

Emerging markets private equity industry remains to be modestly researched with sizeable need to generate awareness of the private equity industry in Africa. The South Africa private equity industry in particular has not had an extensive study since 2006 was undertaken by Missankov et al. (van Niekerk & Krige, 2009), therefore a conclusion of the other country attractiveness factors not covered in this study is good starting point for future research.

Another are worthy of future research would be a comparative analysis of the continents private equity market taking into account the increasing focus on Africa by the investors. This may include comparing countries or regions against each other following on the suggestion by Chikaonda (2012) using South Africa as a base given its historic performance.

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Appendix 1: Consistency Matrix

Propositions/Questions	Literature Review	Data Collection Tools	Analysis
<p>Research question 1</p> <p>What factors led to the growth and attractiveness of the South African private equity industry as an emerging market?</p>	<ul style="list-style-type: none"> • Groh, Liechtenstein, Lieser and Biesinger, 2015 • McPhee and Benjamin, 2015 • Groh, 2009 • Klonowski, 2013 • Casey, 2014 • EMPEA, 2015 • van Niekerk & Krige, 2009 • SAVCA, 2013, 2015 • Jones & Mlambo, 2013 • Portman; 2010 • Schwab, 2014 	<ul style="list-style-type: none"> • Secondary data • Semi-structured interviews 	<ul style="list-style-type: none"> • Constant comparative frequency analysis • Content analysis with coding
<p>Research question 2</p> <p>How does these factors compare with those in other markets?</p>	<ul style="list-style-type: none"> • Groh, Liechtenstein, Lieser and Biesinger, 2015 • Groh, 2009 • McPhee and Benjamin, 2015 • Klonowski, 2013 • Casey, 2014 • EMPEA, 2015 • SAVCA, 2015 • Jones & Mlambo, 2013 	<ul style="list-style-type: none"> • Secondary data • Semi-structured interviews 	<ul style="list-style-type: none"> • Constant comparative frequency analysis • Content analysis with coding
<p>Research question 3</p> <p>How important is geographic location to the private equity capital providers?</p>	<ul style="list-style-type: none"> • Groh, Liechtenstein and Lieser, 2013 • McPhee and Benjamin, 2015 • EMPEA, 2015 	<ul style="list-style-type: none"> • Secondary data • Semi-structured interviews 	<ul style="list-style-type: none"> • Constant comparative frequency analysis. • Content Analysis

Appendix 2: Approval letter

**Gordon Institute
of Business Science**
University of Pretoria

Dear Lesego Molatliwe

Protocol Number: Temp2015-01742

Title: Private equity growth in emerging markets: A South African case study

Please be advised that your application for Ethical Clearance has been APPROVED.

You are therefore allowed to continue collecting your data.

We wish you everything of the best for the rest of the project.

Kind Regards,

Adele Bekker

Appendix 3: Consent form

Interview Consent Form

Dear Participant

I am conducting research into the growth of Private Equity market in emerging markets focusing on the South African case study. The study aims to find out more about the reasons why the South Africa private equity market is regarded as amongst the most advanced in emerging markets resulting in its continued growth and attraction to investment capital at a faster rate than other emerging markets.

Our interview is expected to last about an hour, and will focus on three of the six factors contributing to country attractiveness as measured by the Ernst & Young and IESE Business School Centre for International Finance.

Kindly note that your participation is voluntary and you can withdraw at any time without penalty. I assure you that all your data will be kept confidential. If you have any concerns, please contact me or my supervisor. Our details are provided below:

Researcher Name: Lesego Molatlhwe

Email: lmolatlhwe@gmail.com

Phone: 072 601 8368

Research Supervisor: Matthew Birtch

Email: birtchm@gibs.co.za

Phone: 082 939 2672

Signature of participant: _____ Date: _____

Signature of researcher: _____ Date: _____

Appendix 4: Questionnaire

Questionnaire guideline for General Practitioners

Introduction to questionnaire

South Africa continues to be the only African country to be ranked in the top 40 by the annual global venture capital and private equity country attractiveness index which is sponsored by Ernst & Young and IESE Business schools Centre for International Finance (CIF). The research measures the attractiveness of countries for investors in the venture capital (VC) and private equity (PE) asset classes and ranks South Africa as the third attractive emerging market after China and India. Countries attractiveness for PE & VC investors is ranked according to the following criteria: economic activity; depth of capital markets; taxation; investor protection and corporate governance; human & social environment and entrepreneurial culture and deal opportunities.

The following questions attempt to derive an understanding of the reasons why South Africa remains an attractive destination for private equity investment with particular focus on the following factors; economic activity; depth of capital markets and human and social environment. In this attempt, please apply your knowledge based on your fundraising experience as a practitioner in the South African market.

Questions:

Economic Activity

- 1) What dynamics do you encounter with private equity capital providers when raising funds?
- 2) What concerns do they raise in relation to South African private equity market?
- 3) What considerations do they raise if you indicate intentions to invest in other African countries?
- 4) In your view does geographic location matter for capital allocations by private equity funders?

Depth of Capital Markets

- 5) Do you think South African firms use differing investment and exit strategies when compared to other emerging markets?
- 6) Are the South African capital markets adequately structured to support these strategies?
- 7) Do you find it easier to exits through listing or alternative mechanisms at investment maturity?

- 8) Does the South African market have a reasonable number of participants to absorb and stimulate private equity growth? *Idea of this question is to determine if there is space for additional players or is the space saturating?*

Human and Social Environment

- 9) What is the investment community perception of fraud and bribery when doing business in South Africa?
- 10) How does this perception affect their decisions on capital allocations when raising funds?
- 11) In your view does South Africa have sufficiently skilled private equity practitioners when compared to advanced markets?
- 12) How much weight do you find that funders place on the source (location – international versus local) of the principal and teams experience when making capital allocation?

Appendix 5: List of codes

- a) Africa as risk diversification
- b) Concerns
- c) Entrepreneurship
- d) Exit strategies
- e) Forex
- f) GDP performance
- g) Geography requirements
- h) Impact investing
- i) Importance of local talent
- j) Investing in continent
- k) Investment strategies
- l) Investors perceptions
- m) Local talent in Africa
- n) Market liquidity
- o) Market participants
- p) Minority interests protection
- q) On Money flows
- r) On Risk-Return
- s) On Training
- t) Perceptions mitigants
- u) Preferred exits methods
- v) Preferred investing strategy
- w) Quality of GP- Track record
- x) Regulation
- y) Rule of law
- z) SA PE Industry
- aa) SA PE Skills adequacy
- bb) Skills emergent factor
- cc) Support for participants